

# Fixing Social Security

**A Statement by the  
Research  
and Policy  
Committee  
of the Committee  
for Economic  
Development**



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## RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY

The Committee for Economic Development is an independent research and policy organization of some 250 business leaders and educators. CED is nonprofit, nonpartisan, and nonpolitical. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This Committee is directed under the bylaws, which emphasize that "all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group." The Committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending

specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

*Except for the members of the Research and Policy Committee and the responsible subcommittee, the recommendations presented herein are not necessarily endorsed by other trustees or by the advisors, contributors, staff members, or others associated with CED.*





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\*Voted to approve the policy statement but submitted memoranda of comment, reservation, or dissent. See page 59.

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## Purpose of This Statement

The Committee for Economic Development has a long-standing interest in retirement and Social Security policies. Since its founding in 1942, CED has been unique among business organizations in developing specific proposals for wrestling with important public issues. Social Security is one of those issues. It is a massive public program that affects us all and is unsustainable in its present form.

When the Trustees of CED began their study of Social Security over a year ago, we felt it important to reach consensus on basic goals for the next century. We concluded that while in need of reform, the current system has been enormously successful in eliminating poverty among the elderly and that the basic Social Security safety net therefore should be retained.

We also concluded that Social Security is facing not one, but two threats. The first is fiscal insolvency. If no changes are made, the Social Security system will careen toward a failure to meet its obligations by 2029, if not much earlier. Second is political insolvency — the serious crisis in confidence in the system which is eroding public support. Younger workers are, with good reason, especially skeptical, believing correctly that it will provide a very poor, even negative, return on their contributions to the system.

The reforms we developed were also guided by our strong concern over the low U.S. saving rate. Inadequate national saving jeopardizes future economic growth and future living standards. We believe that any serious Social Security reforms should have a positive effect on national saving.

The actions recommended in this statement can preserve the Social Security safety net for future generations without an increase in the payroll tax. Our recommendation for mandated,

supplemental private saving accounts for every worker will assure more than a bare-bones retirement benefit, with an improved “rate of return” for younger workers. It will also help restore public confidence in the system and increase national saving.

But the dual goal of having a Social Security system that is “fair” to older workers and retirees and “there” for younger and future workers can only be achieved at an affordable cost if the nation acts soon. Delay will ultimately be very, very costly to the future workforce.

In this report, we draw on the analysis and recommendations of many scholars and researchers and on CED’s strong body of work in this area. The most recent statement, *Who Will Pay For Your Retirement? The Looming Crisis*, was issued in 1995. While that statement focused primarily on private pensions, it issued an early warning on Social Security and cautioned that “merely passing the burden to future generations is both inequitable and bad economics.”

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## ACKNOWLEDGMENTS

I offer sincere thanks to the outstanding CED subcommittee of Trustees and advisors who prepared this report. They are listed on page viii.

The chairman of the CED subcommittee on Social Security is Bruce K. MacLaury, President Emeritus of The Brookings Institution. Bruce’s leadership in guiding us through these complex issues was extraordinary, and we are very grateful to him. We are also indebted to Project Director William J. Beeman, CED’s Vice President and Director of Economic Studies.



His knowledge and clarity of thought were invaluable. Thanks are also due to CED Research Associate Andrew Haggard and to Carol Alvey, Secretary of the CED Research and Policy Committee.

Finally we are grateful for the hundreds of corporations, foundations, and individuals contributing annually to CED's policy program. These contributions provided most of the support for this project. We also acknowledge the supplemental project funding provided by Merrill Lynch & Co. Foundation, Inc., The Prudential Foundation, Northwestern Mutual Life Foundation, UNUM Foundation, The Blackstone Group, and Morgan Stanley Group, Inc.

Josh S. Weston  
*Chairman*  
*CED Research and Policy Committee*



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## Chapter 1

# Introduction



Since the first benefits were paid in 1940, Social Security has greatly improved the economic status of retired Americans. But uncontrollable demographic trends pose a great challenge to the future viability of this program. In about a decade, the baby-boom generation will begin to retire, generating such a sharp rise in Social Security spending that the retirement program will be bankrupt unless fundamental reforms are implemented beforehand.

The Social Security retirement program is vital to the nation and must be reformed promptly to place it on a sound financial footing and to preserve its benefits for future generations of retirees, including today's young workers who are losing confidence in the system. The retirement program, more formally known as the Federal Old-Age and Survivors Insurance (OASI), is one of the most successful social programs in U.S. history. Social Security benefits have improved the economic well-being of tens of millions of retired workers and their families. For many participants, retirement and survivors' benefits have provided an indispensable source of income, saving their families from severe financial distress. The decline in poverty rates for the elderly is strong evidence of the overall beneficial effects of this program.

Like most Americans, we believe that the basic objective of Social Security — to protect the economic security of retirees — is sound and that the nation must not falter in its commitment to it. At the same time, because of the challenge posed by the aging of the U.S. popu-

lation, substantial change in the Social Security system is inevitable; if no action is taken, the system will go broke. When the baby-boom generation begins to retire, the system's current operating surplus will quickly vanish and the trust fund balances will be drawn down rapidly. When the trust funds are depleted, it will be impossible to preserve the system without a very sharp and disruptive cut in benefits or a very large and inequitable rise in the tax burden on future workers.

Fortunately, such an outcome is avoidable if reforms are enacted promptly. Because Social Security is such a politically sensitive program, political leaders have been loath to rectify fiscal imbalances in the past until a crisis appeared imminent. **But it is imperative now that policy makers initiate reforms long before the cupboard is bare, because the cost of restoring fiscal balance rises substantially each year that action is postponed. In addition, workers must be given advance notice about any significant changes in the system, so that they can make appropriate adjustments in their retirement saving and in the number of years they plan to continue working.** Consequently, we recommend that important structural changes be enacted soon and gradually phased in so that the nation's commitment to Social Security can be kept without placing too great a burden on future workers.

Unfortunately, the fiscal imbalance in the Social Security program is not the only problem that must be addressed by Social Security

reform. Equally important is the fact that Social Security, as currently designed, creates serious inequities between generations. Unlike their parents and grandparents, who benefited greatly from Social Security, many of the present generation of young workers and most of their children will be saddled with a payroll tax burden that will most assuredly exceed the benefits they will receive. Not surprisingly, polls indicate that young people are losing faith in the Social Security program because they believe that the government cannot keep its promises to them. They correctly perceive that the present system will remain solvent only if benefits are cut, or taxes are raised, and that either change will reduce the investment return they receive from contributions to Social Security.

In this statement, CED recommends a cohesive package of reforms that can deal effectively with both the insolvency and the intergenerational inequity problems while preserving the fundamental goals of the original system. We believe that this can be done without reducing benefits to *current* retirees, raising payroll tax rates, or placing an unacceptable burden on future generations.

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## A BRIEF DESCRIPTION OF CED REFORMS

**THE BASIC SYSTEM.** The CED proposal retains the existing government-funded Social Security retirement program. However, to make the system solvent, several necessary, though painful, changes in the existing system would be phased in gradually, including the following:

- For **upper- and middle-income workers** retiring after the year 2000, initial benefit levels, which currently grow in line with wages, would increase more slowly.
- The **normal retirement age (NRA)**, currently 65 years, would be raised by two months per year, beginning in 2000, until it reaches 70 years in 2030. This change would

reduce *lifetime* benefits relative to current law, which provides a smaller increase in the NRA.

- Although CED believes that an extended work life will be a necessity for most workers in the future, **we do not recommend an increase in the early eligible retirement age**, which is currently 62 years.<sup>1</sup> However, the actuarial discount at age 62 would be substantially larger because of the increase in the normal retirement age.
- The **federal income tax** would apply to all benefits from the basic program in excess of contributions made by the worker, with additional revenues deposited in the Social Security trust funds.
- A reduction in benefits for **nonworking spouses** would be phased in gradually.
- **Earnings tests** for beneficiaries, which reduce incentives for older participants to work, would be **eliminated**.
- **Coverage would be expanded** to require participation by all future state and local government employees. Participation in Social Security by state and local employees currently enrolled in state or local pension plans would be optional.

The first four are high priority changes that would ensure the system's solvency, while the remaining changes would improve equity among participants as well as economic efficiency.

**A NEW SECOND TIER.** In order to restore confidence in the Social Security system and to compensate for reduced growth in benefits in the existing program (which is necessary to restore the system's fiscal balance), CED proposes the creation of privately owned, personal retirement accounts (PRAs):

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1. Several CED trustees favored an increase in the early eligible age (EEA) as a signal to workers that, in view of ongoing demographic changes, they should begin to plan now for an extended work life.

- **Both employers and employees** would be required to contribute 1.5 percent of payroll to privately owned and held personal retirement accounts. (The self-employed would contribute the entire 3 percent.) These mandatory accounts would receive preferential tax treatment similar to 401(k) plans, and would be subject to appropriate fiduciary regulations, including a requirement that accumulated funds be preserved for retirement.

PRAs would be an add-on to the proposed less generous but solvent Social Security program and an addition to existing voluntary tax-preferred private retirement programs. Although PRA accounts would require some new regulations, **no new government bureaucracy would be created.** PRAs would give young workers an opportunity to earn higher investment returns than are possible from the basic system.

Thus, the CED plan would create a two-tier system: (1) a fiscally balanced basic benefit; that is, the present “defined benefit” program with spending growth cut sufficiently to make the system solvent; and (2) a new “defined contribution” program that would involve mandatory contributions to PRAs.<sup>2</sup> If this two-tier system is enacted promptly, the economic safety net now provided by Social Security can be preserved without overburdening future workers. The economic well-being of low-income retirees would be protected because most of the benefit reductions in the current system (though not the increase in the normal-retirement-age) would be limited to middle and upper income participants. PRAs, which would provide an additional source of retirement income for all retirees, would be particularly valuable for those whose benefits from the defined benefit system are cut. Intergenerational equity would be

2. The term “defined benefit” refers to plans that promise a specific benefit, normally determined by a formula relating to length of service and compensation. “Defined contribution” plans promise a specific contribution to a fund.

improved by increasing the importance of benefits derived from a funded system and by offering an opportunity for younger people to receive adequate investment returns on their contributions.

This CED plan provides a retirement saving program for workers not covered by a retirement plan, including part-time and contingent workers who frequently do not have access to private retirement programs. Finally, and importantly, the CED program would generate a substantial increase in national saving that would help to boost long-term economic growth and thereby make it easier for the nation to support the growing elderly population. Without such reform, the nation will confront the very unpleasant choice of a substantial reduction in the economic status of the elderly or an economically damaging and unfair burden on future generations of workers (see “CED Rejects Both Increased Tax Burdens . . .,” page 4).

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## HOW AN AGING POPULATION WILL AFFECT THE FISCAL CONDITION OF SOCIAL SECURITY

The aging U.S. population is an enormous challenge to the Social Security retirement program because of the way the system is financed and the current benefit formula. The Social Security system represents a compact between generations whereby present-day workers pay taxes to support current retirees in return for the expectation of support from future generations of workers. Such a pay-as-you-go system can work when the ratio of retirees to workers is not too high, but this will not be the case in the future.

**DEMOGRAPHIC CHANGE.** The share of the U.S. population that is 65 years of age and over is projected to rise very sharply, beginning in little more than a decade (Figure 1, page 6). This demographic shift reflects the aging of the “baby-boom” generation and the decline in labor force growth associated with



## **CED REJECTS BOTH INCREASED TAX BURDENS ON FUTURE GENERATIONS AND THE CONVERSION OF SOCIAL SECURITY TO A PRIVATE PROGRAM BY DIVERTING PAYROLL TAXES TO PRIVATE ACCOUNTS**

CED studied and rejected proposals now being circulated that would convert the existing Social Security system into a private retirement program by directing all or a substantial portion of payroll tax contributions to private retirement plans. CED also opposes proposals for raising payroll tax rates in future years as a means of maintaining benefits and ensuring the system's solvency. Higher payroll tax rates would have adverse effects on labor markets and on the economy generally. More important, payroll tax increases would raise the lifetime tax burden for younger workers much more than for older workers and, thereby, greatly exacerbate the problem of inter-generational inequity and further erode support for Social Security by younger workers.

CED opposes the full privatization of Social Security for two reasons. First, we believe that a system of government-provided basic benefits is needed to protect the economic security of all participants, especially lower-income retirees and those who experience economic setbacks. This "safety net" aspect of Social Security (especially the indexation of benefits for inflation and the income-redistribution element of the program) cannot easily be provided by the private sector.

The second reason for CED's opposition to proposals for converting Social Security to a private program involves budgetary considerations and costs that would be placed on future workers. Converting Social Security from a pay-as-you-go system to a funded system by diverting payroll taxes to personal saving accounts would impose a substantial burden on young workers during the transition period because they would be required to simultaneously fund their own retirement and pay for the retirement of current retirees (and older workers who would remain under the current program) either by raising additional taxes or

by increasing the federal deficit. These additional transition costs would exist for the entire period during which benefits under the existing program continue to be paid. Of course, the cost of PRAs, included in the CED proposal, is also a significant burden for some younger workers, but it does not require increased deficits (or increased taxes) to keep the current system afloat and the worker would own all contributions to PRAs.

Most of the proposals for converting Social Security to a private pension pay for at least a part of the transition costs by increased federal deficits. In several proposals, a large portion of payroll tax revenues would be transferred to private accounts and the benefits to retirees in the present system would be maintained or reduced by much less than the revenue loss. Consequently, the rise in the federal debt would be massive. (If all OASDI taxes had been placed in private accounts in 1995, for example, the federal deficit for that year alone would have been \$359 billion higher.) But federal deficits also place a burden on future workers.<sup>(a)</sup> Increasing the federal debt might postpone costs, but it certainly would not eliminate the burden of "privatization." Interest costs alone on such a debt burden would represent a huge additional budgetary cost that would further crowd out productive investments. In contrast to such proposals, the CED plan, which would make the existing Social Security program solvent, would substantially *reduce* future budget deficits. CED has long favored a deficit-reduction policy as a means of raising national saving and encouraging longer-term economic growth.

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(a) One version of this proposal would involve the issuance of "recognition bonds" to current participants. For reasons explained in Chapter 3, CED believes that recognition bonds are not an attractive option.

the succeeding “baby-bust” generation. The term “baby-boom generation” refers to the exceptionally large group of people born after World War II, from 1946 to 1964. At the end of this period, birthrates fell sharply and have remained relatively low (Figure 2, page 6). In addition, with improvements in health care, safer working conditions, and healthier lifestyles, the average life span of Americans is expected to continue to rise. Not only is the number of workers surviving to retirement age rising, but the number of years spent in retirement is also increasing for both men and women (Figure 3, page 6).

Recent projections made by the Social Security Administration indicate that between 1990 and 2030, the number of people of retirement age (65 and older) will more than double, but the number of working people (age 20 to 64) will increase by only 25 percent (Figure 4, page 7). Over the same period, the ratio of covered workers to Social Security beneficiaries is expected to decline sharply from 3.4 to 1 to 2.0 to 1 (Figure 5, page 7). It is highly unlikely that immigration or any other reasonable public policy could change demographic trends sufficiently to prevent a sharp decline in this ratio.<sup>3</sup> Consequently, with the current pay-as-you-go system, each Social Security contributor must support a growing number of retirees.

#### THE IMPACT ON SOCIAL SECURITY.

The Social Security program is currently experiencing a substantial positive cash flow (about \$65 billion per year), but it will begin to run operating deficits soon after the first baby boomers begin to retire. Thereafter, payroll taxes, at their present rates, will not be sufficient to finance promised benefits. More rapid growth in productivity and wages could only partially offset the demographic change, because, as explained in Chapter 2, the Social Security benefit formula is designed to make retirees’ initial benefits (the amount they receive in the first year of retirement) grow in line with the rise in wages. (Once benefits

begin, they are adjusted for inflation rather than wages in subsequent years.)

Social Security’s fiscal problems are not very far in the future: The oldest of the baby boomers will be eligible for early retirement benefits in 2008. Recent projections by the Social Security Administration indicate that with no change in policy, OASDI outlays will exceed payroll tax revenues by the year 2010 and all tax revenues (including the taxation of benefits) by 2012.<sup>4</sup> (The system’s total cash flow (including interest earnings) will turn negative by 2019 (Figure 6, page 8), and trust fund balances will be exhausted by 2029 (Figure 7, page 8). However, projections of positive trust fund balances by the Social Security Administration have been revised downward in nearly every annual reestimation, and many believe that it is more realistic to assume that funds will run out much sooner. Moreover, adverse fiscal effects will be widely felt long before funds are exhausted. The federal government will have to raise taxes, sell more debt to the public, or cut spending in order to make interest payments to Social Security and redeem the special-issue Treasury bonds held by the trust funds as soon as outlays exceed tax revenues. The exhaustion of Social Security trust fund balances is not an abstract concept to young workers. Workers who will be 65 years old in 2029 are now 33 years old.

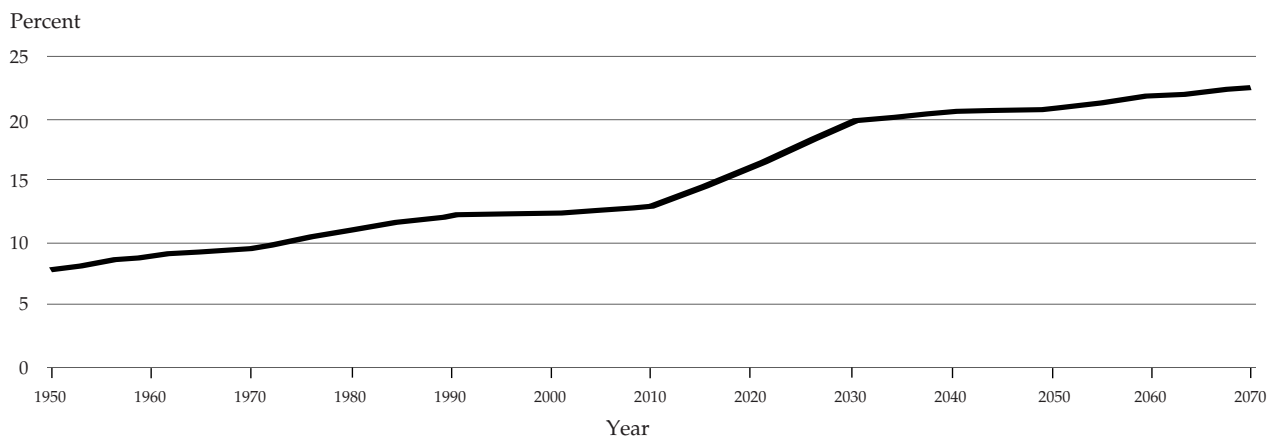
3. Substantial immigration is already incorporated into these projections; the extremely large increase necessary to halt the decline in the worker-retiree ratio suggests that the impact of immigration will not be significant. For a brief analysis, see *Who Will Pay For Your Retirement? The Looming Crisis* (New York: Committee for Economic Development, 1995) pp. 25-27.

4. The reform measures proposed in this statement pertain only to the Social Security *retirement* (OASI) program. (The Disability Insurance (DI) component of Social Security is very complex and deserving of separate study.) References to the solvency of the Social Security system include all of Social Security (i.e., OASDI), because in the past, Congress has shifted revenues from one program to the other as needed. For example, in 1994, additional funding for the DI trust fund was provided by reallocating a portion of the OASI tax rate to DI. Social Security Administration, *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, 1996 (Washington, D.C.: U.S. Government Printing Office, 1996), p. 15.

**Figure 1**

## Persons Age 65 and Older as a Percentage of Total U.S. Population

(1950 to 2070)

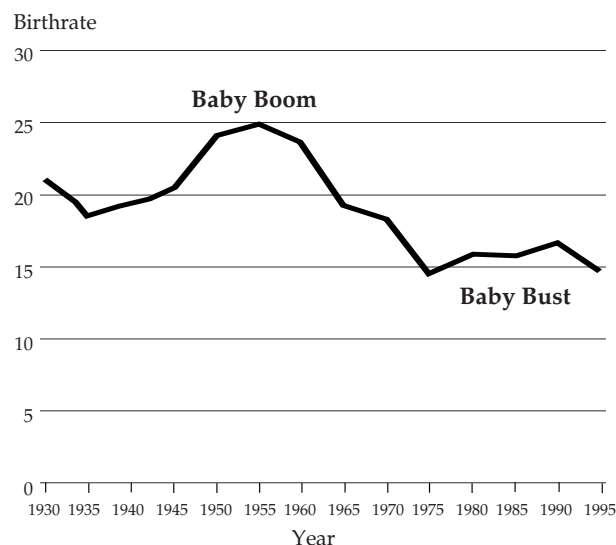


SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Funds*, 1996 (Washington, D.C.: U.S. Government Printing Office, 1996), p. 147.

**Figure 2**

## Postwar Baby Boom, Followed by Baby Bust

Birthrate per 1,000 Persons, 1930 to 1995



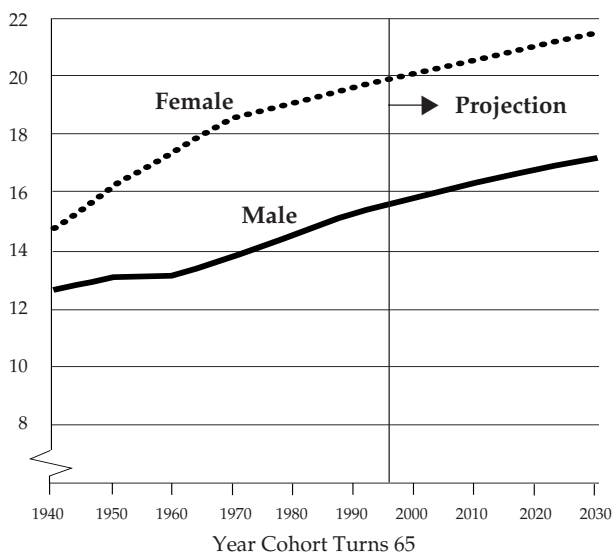
SOURCE: U.S. National Center for Health Statistics, *Vital Statistics of the United States* (Washington, D.C.: U.S. Government Printing Office), annual, and *Monthly Vital Statistics Report*.

**Figure 3**

## Projected Average Life Expectancy for Persons Aged 65

(1940 to 2030)

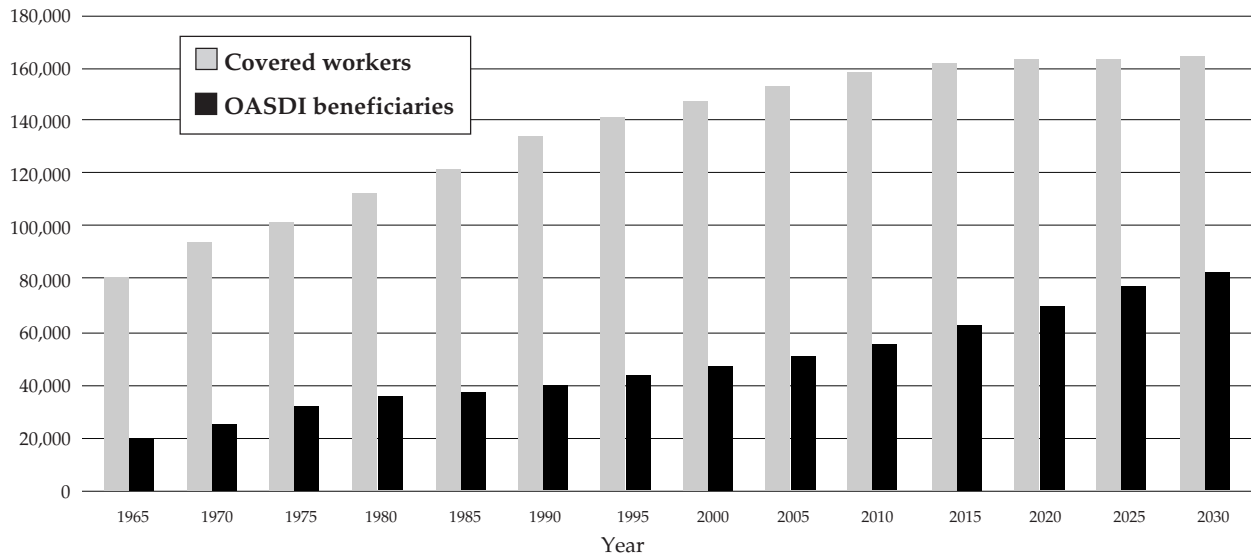
Life Expectancy from Age 65 (Number of Years)



SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 61.

Figure 4

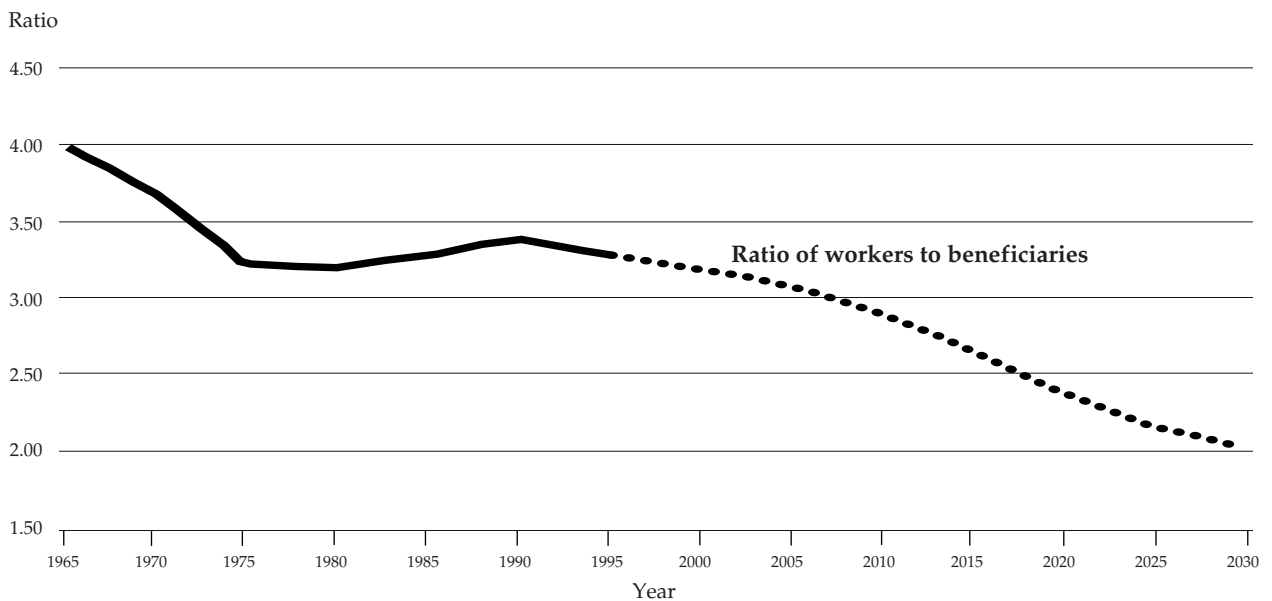
**The Number of Retirees Is Projected to Grow Faster than the Number of Workers Who Will Support Them. . .**



SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 122.

Figure 5

**. . . Causing the Ratio of Workers to Retiring Baby Boomers to Fall**



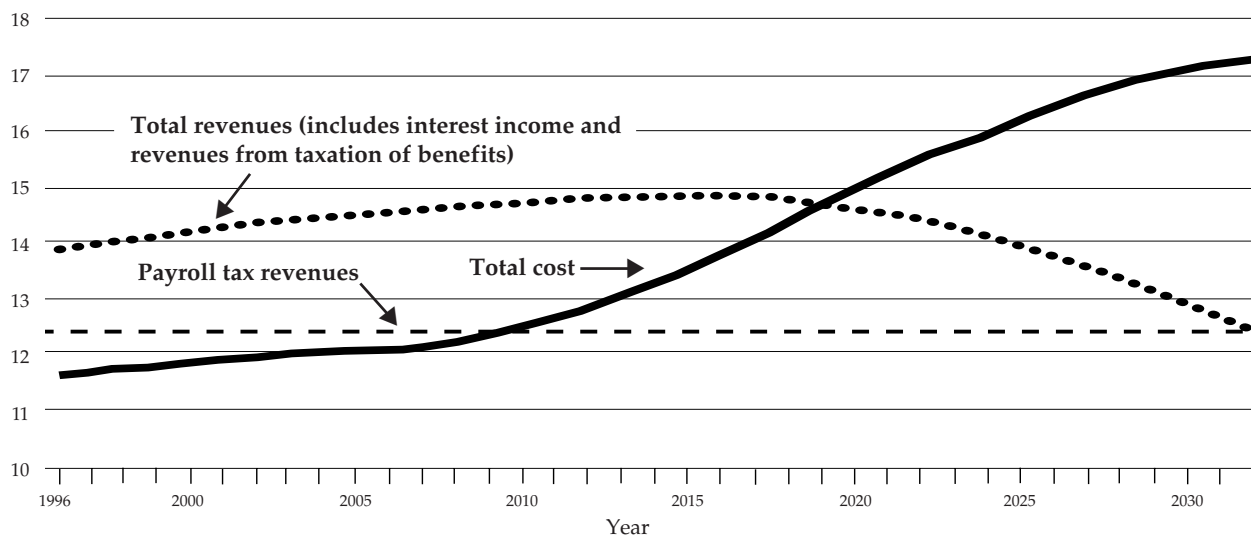
SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 122.

**Figure 6**

## Projected Social Security Costs and Income Are Not in Balance

### OASDI, 1996 to 2032

Percent of Taxable Payroll



NOTE: The cost rate and income measures are presented as a percentage of total payroll subject to OASDI taxation. The total cost rate includes benefit payments, administrative expenses, and transfers to the Railroad Retirement Fund. In 2010, the total cost is projected to exceed payroll tax revenues. In 2019, the total cost will exceed total revenues.

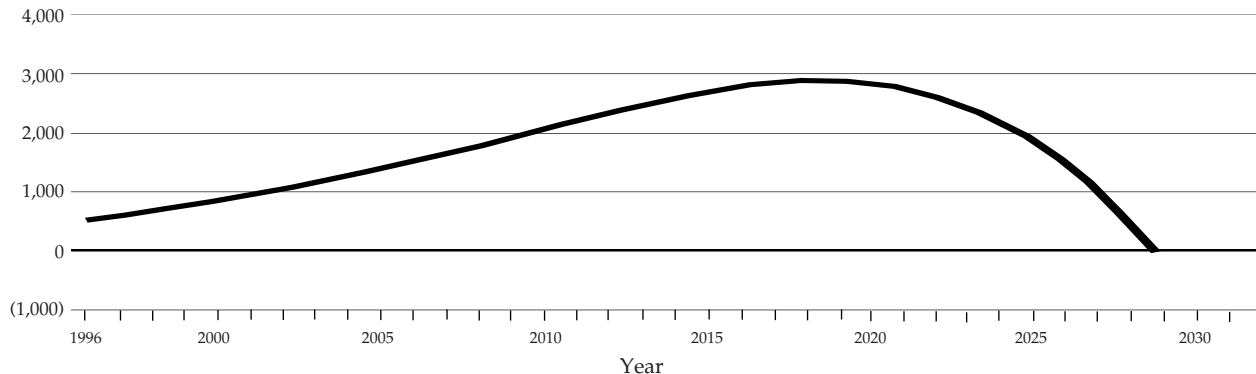
SOURCE: Social Security Administration, Office of the Actuary, unpublished data, June 6, 1996, and Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996.

**Figure 7**

## Trust Fund Assets Will Be Depleted by 2029

### Total Fund Assets, 1996 to 2030

Billions of Current Dollars



NOTE: The trust fund will peak in 2019 at over \$2.8 trillion (current).

SOURCE: Social Security Administration, Office of the Actuary, unpublished data, June 6, 1996.



According to the Social Security Administration's intermediate projection, the OASDI program's annual deficit would be more than 1.5 percent of GDP in the first year after the trust fund runs out (2030), rising to nearly 2.0 percent of GDP by 2070 (the last year of available projections) if no reform is enacted. Moreover, if the Treasury borrows from the public to redeem the special issues held by the trust funds (instead of raising taxes, for example), the effect on the total federal deficit would be substantially greater than the increase in the Social Security deficit because the huge increase in the Treasury debt held by the public would cause interest costs to rise very rapidly. To place these figures in perspective, spending for all of defense is currently about 3.5 percent of GDP and total federal revenues are only 19 percent of GDP.

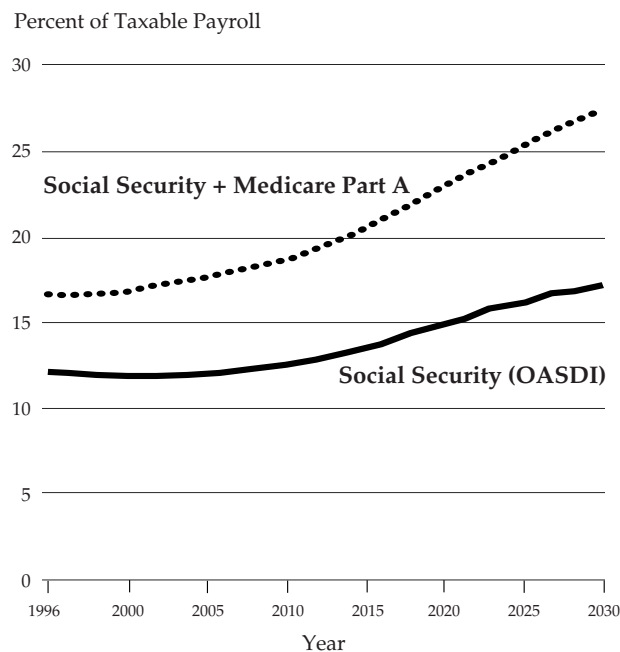
On an actuarial basis — considering the present value of all future OASDI income and outlays — Social Security is currently underfunded by about \$2.5 trillion.<sup>5</sup> If the retirement system was brought into balance by raising payroll tax rates in the future just enough to meet projected outlays, OASDI payroll tax rates would have to be raised from 12.4 percent currently to 17.1 percent by 2030, according to the Social Security Administration's intermediate projection.

This projected tax burden makes a compelling case for major changes in the Social Security program now. But the necessity for Social Security reform is made even more acute when the potential tax burden arising from other entitlement programs for the elderly is taken into account. Demographic changes will have a huge impact on the growth of Medicare and Medicaid expenditures as well as on Social Security (which together constitute 40 percent of federal spending). Medicare is expected to grow more rapidly than Social Security and to run out of funds much sooner. A rough indi-

cation of the potential burden is provided by the Social Security Administration's projections indicating that by the year 2030, outlays for the OASDI system and Part A of Medicare (Hospitalization Insurance, also financed by payroll taxes) will equal nearly 28 percent of taxable payroll if no reform is enacted (Figure 8). Clearly, a payroll tax burden of that magnitude would have serious economic consequences for workers and for the economy. In fact, recent long-range projections made by the Congressional Budget Office (CBO) show that entitlement programs for the elderly (Social Security, Medicare, and Medicaid) have put federal fiscal policy on an explosive, unsustainable path (see "Retiree Entitlements Have Put Fiscal Policy on an Unsustainable Path," page 10).

**Figure 8**

### Without Reform, Outlays for Social Security and Medicare Part A Will Be Nearly 28 Percent of Taxable Payroll by 2030



SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 171.

5. *Report of the 1994-1996 Advisory Council on Social Security, Volume 1: Findings and Recommendations* (Washington, D.C.: January 1997), Table F1, p. 54.

**DELAYING SOCIAL SECURITY REFORM WOULD BE VERY COSTLY.** Political commentators frequently suggest that the problems of Social Security be set aside until Congress has resolved how to manage the more pressing Medicare and Medicaid problems. But this delay ignores the time needed for workers to accumulate savings and adjust their plans for retirement. Changes should be made while the baby boomers are at work and in their prime earning years and still have time to make adjustments. Such a delay also ignores the fact that the cost of restoring fiscal balance is rising, and that postponement would magnify the growing inequity between generations.

According to government projections, an

immediate 2.2 percentage point increase in the combined payroll tax rate at the beginning of 1996 would have restored the 75-year actuarial balance in the OASDI system. If no action is taken until the trust fund runs out, the payroll tax increase required to finance the system on a pay-as-you-go basis would be more than twice as large. (If, instead, a benefit cut option were chosen to restore balance, delay would similarly magnify the size and impact of the cuts.) Moreover, a 2.2 percent payroll tax increase would not be sufficient to achieve a sustained fiscal balance. Because demographic trends are not expected to change greatly, the operating deficit will be very large at the end of Social Security's traditional 75-year evaluation period, even if payroll taxes

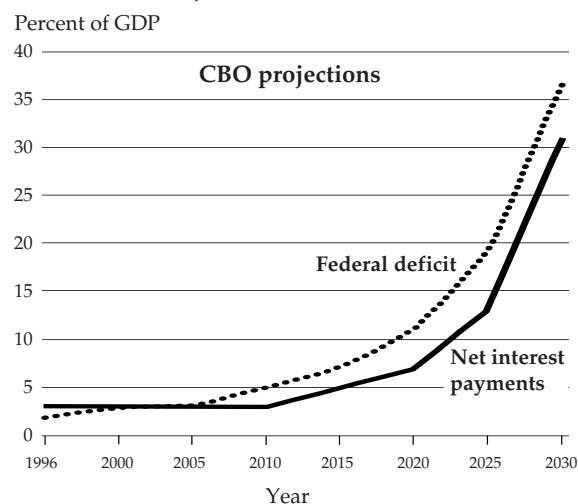
### RETIREE ENTITLEMENTS HAVE PUT FISCAL POLICY ON AN UNSUSTAINABLE PATH

The Social Security solvency problem is one of the major components of the longer-range federal budget crisis. Recent projections made by the Congressional Budget Office (CBO) show that without reform, current entitlement programs will generate an unsustainable increase in federal deficits and debt.<sup>(a)</sup> The CBO report indicates that the basic problem is the impact of population aging on the three largest entitlement programs for the elderly: Social Security, Medicare, and Medicaid. Assuming no change in policy, spending for these three programs would rise from 9 percent of GDP to 18 percent over the period from 1995 to 2030. The interaction of rising federal deficits and rising interest costs required to finance the resulting debt would generate an explosive budgetary situation (Figures 9 and 10). This daunting prospect is inescapable over a wide range of economic and demographic assumptions. In a worst (but perhaps realistic) case, the CBO projections show net interest payments rising from about 3 percent of GDP to 31 percent, the

Figure 9

### Without Reform, Federal Budget Deficits and Interest Costs Would Explode . . .

Calendar Years, 1996 to 2030



NOTE: Deficit calculated using National Income and Products Account (NIPA) accrual basis. CBO estimates based on discretionary spending growth set to the projected growth rate of the economy.

SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997–2006*, p. 80.

are raised immediately by an amount sufficient to restore the 75-year actuarial balance. Each year the projection is moved forward, a deficit year would replace a surplus year, and before long (perhaps in a decade or so), policy makers would again be concerned about the system's actuarial deficit. Thus, it is important that policy changes are sufficient to restore the actuarial balance beyond the 75-year projection period.

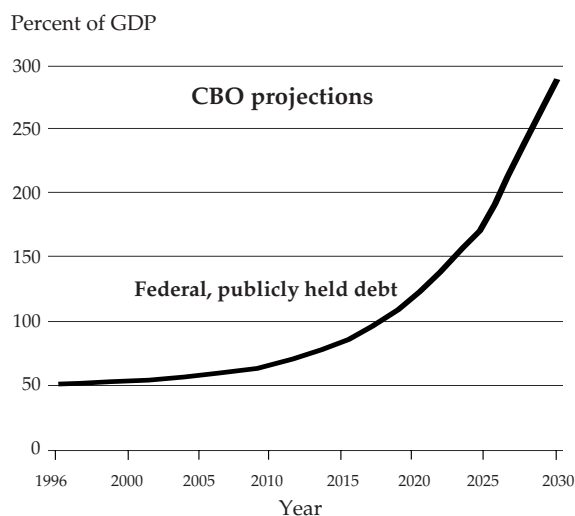
## ACHIEVING EQUITY AMONG GENERATIONS

If Social Security's only problem were that it will be in deficit in a decade or so, the remedy, though painful, would be simple: Cut

benefits and/or raise payroll taxes. But benefit cuts or tax increases lower investment returns on Social Security contributions, and these returns are already very low for younger participants. Why will Social Security provide lower returns to younger workers? Simply put, in the early years, pay-as-you-go systems pay retirees very high benefits relative to taxes paid during the limited number of years they contributed to the system. But as the system matures, lifetime contributions rise relative to benefits of eligible retirees. In the early years the low numbers of beneficiaries relative to the numbers of workers contributing to the system also permitted Congress to raise benefits without placing too great a tax burden on workers. But later on, it became necessary to

**Figure 10**

### ... Producing a Record Debt Burden 1996 to 2030



NOTE: Deficit calculated using NIPA accrual basis. CBO estimates based on discretionary spending growth set to growth rate of the economy. Federal debt is debt held by the public. This does not include interagency holdings (such as the Social Security trust fund or Federal Reserve bond assets).

SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997–2006*, p.80.

budget deficit rising from 2 percent of GDP to 37 percent, and the federal debt held by the public rising from 51 percent to 293 percent of GDP — all in only 35 years (from 1995 to 2030).<sup>(b)</sup>

After examining several scenarios, the CBO concluded that the nation's current budget policies are unsustainable, "even under optimistic assumptions, including favorable demographic trends and historically high rates of productivity growth."<sup>(c)</sup>

Social Security and other entitlement programs for the elderly cannot continue on the current fiscal path. Federal deficits would crowd out private investment spending and squeeze economic growth. At some point, the explosion of debt would bring about a collapse of output and employment in the U.S. economy. Thus, our political leaders have no choice but to enact reforms of Social Security and other entitlement programs for the elderly.

(a) Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997–2006* (Washington, D.C., May 1996). See Chapter 4, "The Long-Term Budget Outlook," pp. 69–95.

(b) *The Economic and Budget Outlook: Fiscal Years 1997–2006*, p. 80.

(c) *The Economic and Budget Outlook: Fiscal Years 1997–2006*, p. 69.

raise tax rates for each new generation of workers, so that rising lifetime benefits could be maintained. Consequently, investment returns have declined for each new generation of workers; most of those retiring today receive no better than the average return on conservative investments. But for young workers and those who have not yet entered the labor force, the outlook is grim. Given the present structure of Social Security, most future retirees will receive very low or even negative returns on their contributions (Figure 11).

Reducing benefits for the 37 million Americans, including spouses and survivors who receive OASI benefits today, is an unattractive option. It would place a heavy burden on millions of current retirees whose incomes are heavily dependent on Social Security and who no longer have the option of working. The present Social Security retirement program is

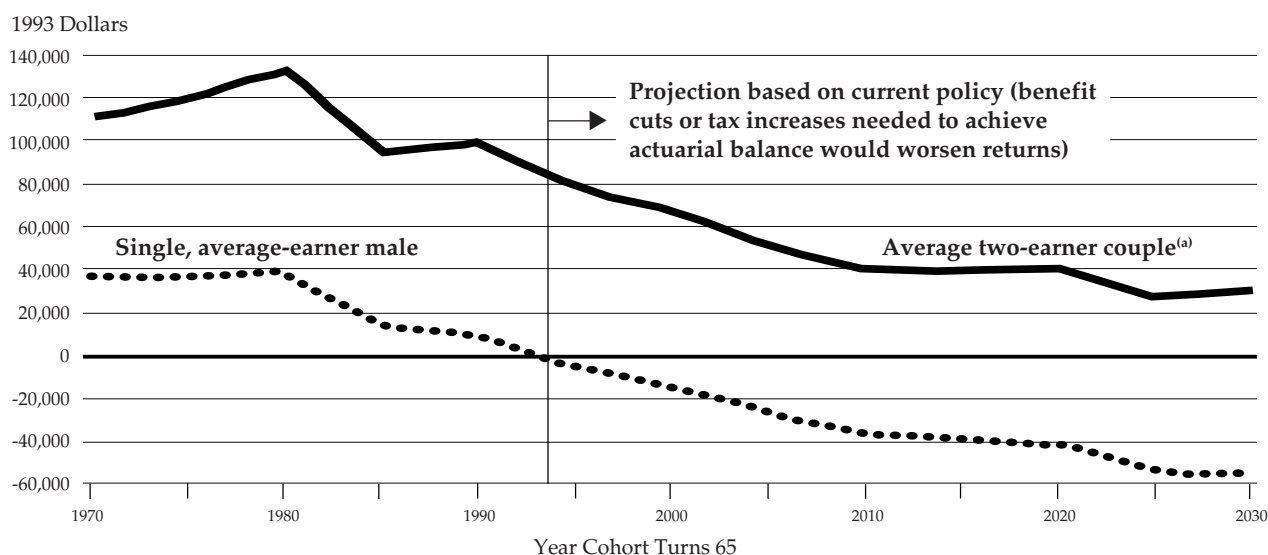
correctly credited with having contributed to the sharp decline in poverty rates among the elderly shown in Figure 12, page 13. Social Security accounts for more than 40 percent of the total income of the elderly and for many, it is their only source of income. Although CED believes that future Social Security spending growth must be trimmed to restore fiscal balance, we believe that cuts in benefits to current retirees (with a consequent return to high poverty rates among the elderly) should be avoided.

A payroll tax increase is also objectionable. The past practice of raising tax rates each generation on the wages of workers in order to finance scheduled benefits has run out its string. Raising tax rates would make the inequity between generations worse and cause political support for the system to decline further. Moreover, as a practical matter, this

**Figure 11**

### The Return on Social Security Retirement Contributions Is Declining and Is Already Negative for Some

Present Value of Expected Benefits Less Taxes Paid (thousands of 1993 dollars)



(a) Average two-earner couple includes one average earner and one low-wage earner (45 percent of average).

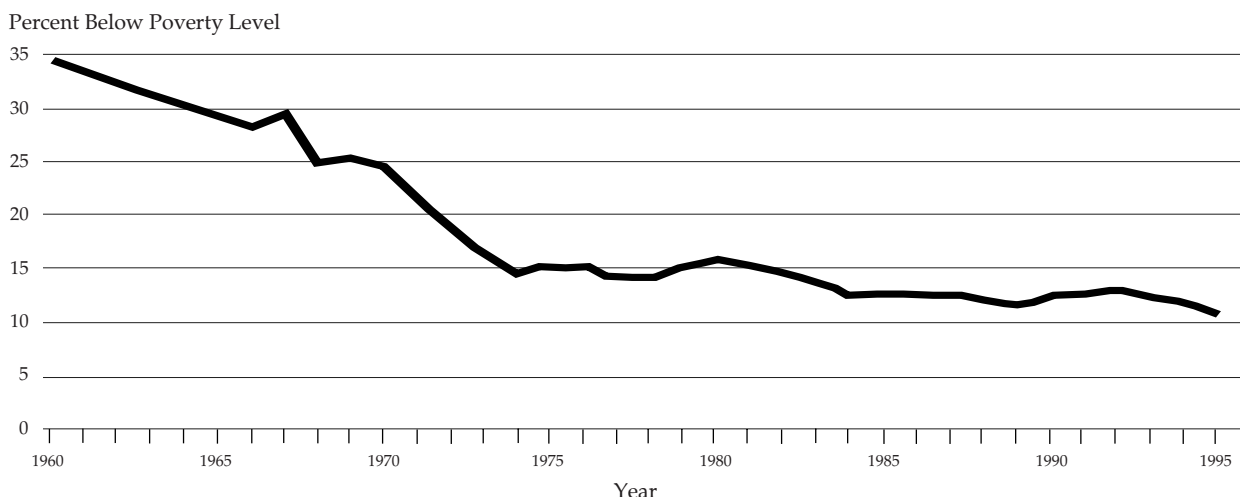
SOURCE: C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform* (Washington, D.C.: The Urban Institute, 1994.) p.287. Assumes 2 percent real interest rate.

Figure 12

## Social Security Has Improved the Welfare of Retirees

### Elderly Poverty Rates Haved Declined

Percent of Persons Age 65 and Older with Income Below Poverty Level, 1960 to 1995



SOURCE: Social Security Administration. *Social Security Bulletin, 1995 Annual Statistical Supplement* (Washington, D.C.: U.S. Government Printing Office, August 1995), p. 163. Based on data from the *Current Population Survey*.

practice could not continue for long. The incentive for tax evasion would rise with each group of new entrants into the labor force, and if these incentives become strong enough, the system would eventually collapse from lack of support.

Reforms designed to improve the long-run solvency of the Social Security program must take into consideration (and limit) the decline in the investment return received by young workers. One way to mitigate the effects on intergenerational equity is to increase reliance on self-funded retirement programs, which is one of the attractions of the PRAs proposed by CED.

## THE SAVING SOLUTION

As the population ages, a rising share of the nation's real output must be transferred from workers who produce goods and services to the non-working retired population.

Although this shift in resources is inevitable, the burden on future workers can be alleviated by increasing national saving and investment. Additional saving will stimulate economic growth and increase the size of the economic pie that must be shared. Unfortunately, national saving has fallen dramatically in the United States in recent years at the very time when demographic conditions call for more saving (Figure 13, page 14).

In an earlier statement, CED proposed policy changes that would encourage increased private saving for retirement in order to reduce the burden on future workers of an aging population and to ensure the economic prosperity of our children.<sup>6</sup> If it is to be effective in easing the burden on future workers, Social Security reform must also make a contribution to national saving and economic growth. The Social Security reforms proposed

6. See *Who Will Pay For Your Retirement? The Looming Crisis*.



by CED would do just that in two ways: First, they would bring the current system into fiscal balance by trimming the growth of expenditures and thereby reduce future federal budget deficits. Second, the CED proposal would generate a sizable increase in private saving. The resulting increase in *national* saving (the sum of government and private saving) would encourage productive investment and stimulate economic growth.

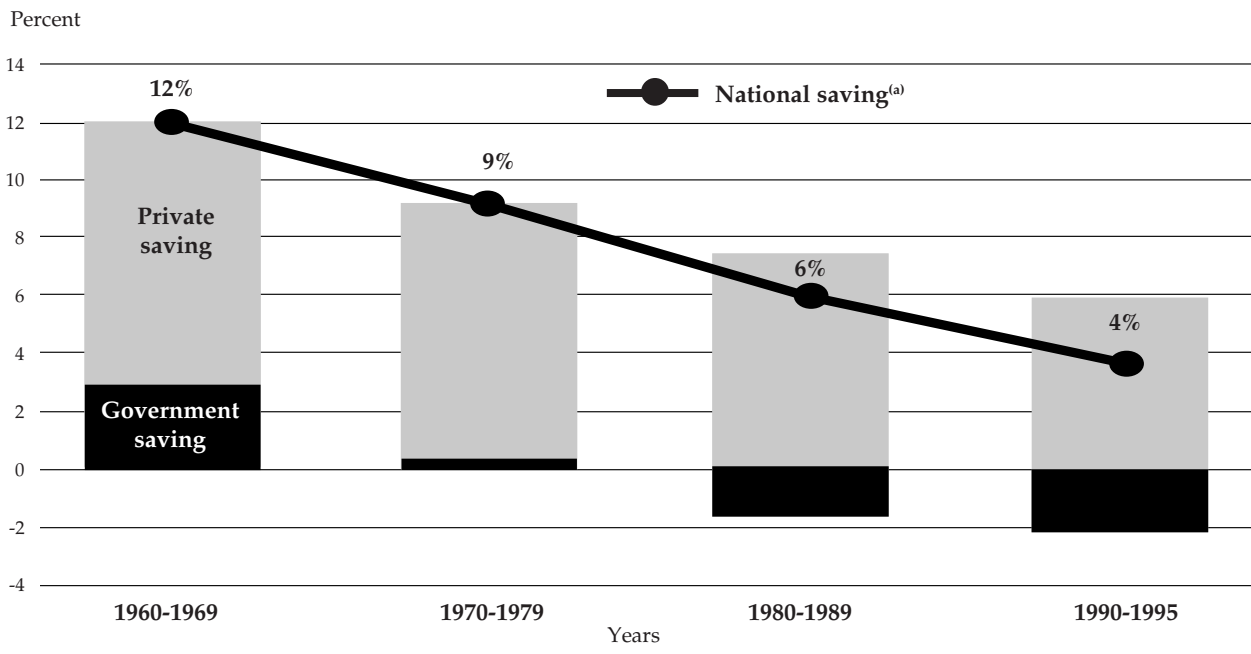
The CED proposal would reduce future federal deficits substantially. Although at least two provisions of the CED proposal (the tax deductibility of contributions to PRAs and the elimination of the earnings test) would have short-term adverse effects on the federal budget deficit, the overall impact of reforms proposed by CED would be to reduce the deficit. Indeed, in the long term, the restoration of fiscal balance in Social Security would gener-

ate a major improvement in the annual federal budget balance, eventually reducing the deficit by 2 percent of GDP annually.

Of course, restoring fiscal balance in Social Security will not lead to higher national saving if the government spends the resulting increase in the trust fund. Reform measures enacted in 1983 attempted to create, temporarily, a partially funded Social Security system in order to bring the system into long-run actuarial balance. For more than a decade, these reforms have enabled Social Security to run an annual cash surplus which is invested in special-issue Treasury bonds. The Treasury credits interest on these bonds to the trust funds. (These interest payments accounted for more than half the Social Security surplus of nearly \$60 billion in 1995). On paper, the total trust fund balances now exceed \$500 billion, which is about 1.5 times annual outlays (Fig-

**Figure 13**

### Low Government and Private Saving Have Lowered National Saving, 1960 to 1995



(a) Net national saving = Net private saving + net government saving. Figures expressed as a percentage of net national product.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts.

ure 7, page 8).<sup>7</sup> But most observers believe that the current Social Security surplus does not add to national saving and productive resources.<sup>8</sup> Instead, the Treasury is simply borrowing from trust funds to spend on other programs. Little is gained by achieving fiscal balance in the Social Security program if the federal deficit is not reduced dollar for dollar, thereby increasing national saving. To be certain that reforms generate additional saving, budgetary measures must be taken to prevent government from spending the positive cash flow in the Social Security program.<sup>9</sup> As a practical matter, this means that the federal government must balance the budget without relying on the temporary surplus in the Social Security accounts.

The PRA accounts would also generate a sizable increase in private (and national) saving. Of course, some individuals and businesses will finance contributions to PRAs by reducing present contributions to private pensions, 401(k)s, etc. To the extent that this form of substitution occurs, there will be less increase in private saving. Moreover, if tax-sheltered PRAs are substituted for saving that is not entitled to tax preference, federal revenues would be reduced, thereby offsetting some of the improvement in private saving. However, a large number of workers, including most contingent and part-time workers, are not currently covered by discretionary employer retirement plans, and many workers have little or no personal savings to shift into the new PRAs. For those with little or no saving, the creation of mandatory PRAs will undoubtedly generate a large increase in saving. Moreover, for many, the experience of owning such assets may encourage additional saving.

CED acknowledges that the requirement for compulsory savings will be difficult for workers at the lowest income levels. However, the alternatives of increased payroll tax rates while still employed or inadequate benefits while retired would be even less acceptable.

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## THE CED PROPOSAL PROTECTS BOTH CURRENT AND FUTURE RETIREES

The CED proposal protects current retirees and older workers while assuring the viability of Social Security for future retirees. It breaks with the past practice of raising tax rates to maintain current benefits, which imposes a larger lifetime tax burden on younger workers. Instead, CED gives highest priority to changes that would gradually slow the growth of benefits in the basic system for new retirees and simultaneously mandate new private, funded retirement saving and benefits for younger workers.

Because the annual projections of the Social Security trust fund balances have been revised downward time and again, **the CED proposal builds in a margin for projection error.** Thus, enactment of the CED reforms could result in a substantial long-run surplus in the retirement program. Consequently, if experience confirms this projection, it may eventually be possible to terminate the phase-in of further cuts in benefits or reduce payroll tax contributions.

The creation of PRAs will help to restore the confidence of young people in the Social Security system by offering an opportunity for a higher return on contributions and giving workers a sense of ownership. Although contributions to PRAs would be mandatory

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7. Social Security tax revenues for 1996 are expected to total about \$386 billion and exceed outlays (\$354 billion) by \$32 billion. Earnings from trust fund investments (expected to exceed \$550 billion at the end of 1996) should generate an additional \$38 billion, bringing the annual surplus to about \$70 billion. *1996 Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 182.

8. To the extent that the Social Security surplus reduces the federal deficit, it could add to national saving. But this does not appear to be the case.

9. If the government adopted a balanced budget requirement for the total deficit that includes Social Security, reforms that increase the Social Security surplus could result in increased spending (or reduced taxes) elsewhere in the budget. To prevent that from happening, the total deficit target would have to be adjusted.

and, in many cases, would raise business costs, these contributions should not be considered a tax because no revenue is received by any government agency and the funds are personally owned and privately invested.

The CED reform program would gradually phase in changes in the Social Security system and thereby avoid serious disruptions

in labor markets and in the lives of retirees. It would protect the economic security of lower-income retirees and over time, further reduce poverty among the elderly. Present retirees and older workers would experience little or no change in benefits from the existing system, though the portion of benefits subject to taxation would rise for some.

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## SUMMARY OF POLICY RECOMMENDATIONS

CED urges Congress and the Administration to implement reform measures without delay that will put the existing Social Security retirement program on sound financial footing. We also recommend that this program retain its existing safety net and redistributive properties whereby benefits relative to contributions are higher for low-income contributors than for higher-income participants. In addition, a new defined contribution component of Social Security should be mandated which, in combination with the existing system, will ensure that all long-time participants receive a retirement income above the poverty line. The new defined contribution system also improves intergenerational equity by giving younger participants an opportunity to receive better returns on contributions than is possible with the present system.\*

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### REFORMING THE EXISTING SYSTEM

With respect to the existing defined benefit program, CED recommends the following reforms:

- **Reduce the Growth in Initial Benefits.** Reducing the growth in the primary insurance amount (PIA), which is the first-year benefit received by an individual who retires at the normal retirement age (NRA), is the most direct and equitable way to trim the growth of prospective benefits gradually and thereby reduce the system's

costs. CED's plan would gradually lower replacement rates for the two higher-income brackets, thereby reducing the growth of future benefits from the existing defined benefit program for middle- and upper-income participants but not for low-income workers.

The growth in the PIA would also be reduced by increasing the number of years of income included in the calculation of PIA from 35 to 40 years. Currently, those who contribute for 35 years are eligible for benefits as high as for those who contribute for a longer period.

- **Reduce the Growth in Lifetime Benefits by Raising the Normal Retirement Age.** The normal retirement age, which has remained at 65 since the system was created, has not been adjusted to compensate for the large increase in life spans in the last half century. This has raised the cost of Social Security dramatically. Congress has enacted legislation providing for a future increase in the NRA to 67, which only partially offsets the rise in average life spans. To further compensate for past and expected increases in life expectancy, CED's plan would raise the normal retirement age by two months per year beginning in 2000 until it reaches 70 years in 2030. Thereafter, the NRA would rise in line with increases in life expectancy.

The early eligible age (EEA), currently 62, would not be changed. CED believes

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\*See memorandum by JAMES Q. RIORDAN, (page 59).

that the option of early retirement should be preserved, especially for those in very demanding work, though with larger actuarial discounts as the NRA is raised.\*

- **Tax Social Security Benefits.** CED recommends that the income tax apply to all Social Security benefits in excess of the contributions made by the worker. (Taxation of benefits derived from a worker's own contributions would constitute double taxation.) With this change, Social Security would be taxed like other contributory programs. Low-income recipients would not be affected because they are exempted from income taxation.
- **Lower Spousal Benefits.** At present, a spouse is entitled to a retirement benefit equal to his or her own benefit or 50 percent of the worker's benefits, whichever is higher. Consequently, the rate of return on contributions is much higher for couples with a nonworking spouse than for others. In order to reduce costs and to improve equity between working and nonworking spouses, CED recommends that retirement benefits for the nonworking partner of a retired couple be reduced gradually until they reach 33 percent of the worker's PIA. CED does not recommend any reduction in the nonworker's survivors benefits which may be as high as 100 percent of the worker's PIA.
- **Eliminate Disincentives to Work.** Current law requires a reduction in Social Security benefits for retirees whose earned income exceeds a specified amount.<sup>10</sup> Congress has enacted legislation that would reduce but not eliminate this penalty for work. The motivations for retaining earnings limitations seem to be (1) concern that there would be a short-run budgetary cost, (2) the presumption that the working elderly reduce the number of jobs available for younger workers, and (3) that Social Security was designed to be an "income replacement" benefit, not a pension. But there

would be no long-run budgetary cost resulting from the elimination of the earned income limitation, and projected demographic changes now imply a shortage of skilled labor in the future rather than a surplus. Elimination of the earnings test would simplify regulation and have a favorable effect on the economy. Consequently, CED recommends the elimination of all earnings tests in determining eligibility for Social Security benefits.

- **Expand Coverage to Include State and Local Employees.** The Social Security system redistributes income from high-income retirees to low-income retirees. CED favors continuation of a redistribution element in the Social Security program. However, CED believes that as a matter of equity, the burden of redistribution must be widely shared, and, therefore that coverage should be universal. Consequently, CED recommends that all new state and local employees be required to become participants in the Social Security system and that current employees be permitted to join Social Security on a voluntary basis.

CED also believes that measures must be taken to ensure that any addition to federal cash flow resulting from Social Security reform be added to national saving rather than used to finance government expenditures.

Although CED strongly endorses the goal of achieving a balanced budget by 2002, we regard this as only an interim goal. Ultimately, policy makers must pursue the more difficult task of balancing the non-Social Security or "on budget" portion of the federal budget, thereby ending reliance on temporary Social Security surpluses. In this way, the Social Security surplus would be used to retire federal debt, and raise national saving, rather than to finance government consumption.

10. In 1996, OASI benefits for retirees under age 65 were reduced by \$1 for every \$2 of earnings above \$8,280. For retirees between 65 and 70, benefits were reduced by \$2 for every \$3 of earnings above \$12,500. The exempt amount for ages 65 to 70 is scheduled to rise to \$30,000 by 2002.

\*See memorandum by LAWRENCE A. WEINBACH, (page 59).



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## THE SECOND TIER: PERSONAL RETIREMENT ACCOUNTS

With respect to the new defined contribution program, CED believes that all *employees* and *employers* should be required to contribute to personal retirement accounts (PRAs). CED believes that the PRA system should be an “add-on” to the current system. Payroll tax revenues should not be “carved out” and contributed to private accounts, because existing payroll taxes are needed to finance benefits under the reformed Social Security plan, which would maintain a basic safety net. So-called “carve out” proposals, which divert payroll taxes to private accounts, present insurmountable budget deficit problems (see Chapter 3).

The PRAs favored by CED would have the following characteristics:

- PRAs would be funded by **mandatory contributions** totaling 3.0 percent of covered payroll, with payments split equally between employees and employers. (The self-employed would contribute the entire 3 percent of covered payroll.)
- PRAs would be **owned by** or attributed to **individuals and directed by them**. Contributions may be **invested in a limited number of broad-based funds that invest in private-sector financial securities**.\*
- Contributions to PRAs would receive **tax-preferred treatment** similar to that accorded to 401(k)s. Individual and corporate contributions would be made from before-tax income, and earnings would accumulate on a tax-deferred basis. Individuals would pay taxes only on future benefits derived from PRAs.
- The accumulated balances in PRAs would be part of the estate of deceased workers in the event of death before retirement.

CED recognizes that employers and employees currently making contributions to retirement plans may redirect a portion of these

contributions to PRAs in order to comply with the mandatory contribution requirement. To the extent that such substitution occurs, labor costs will be unaffected by PRA contributions and retirement saving created by PRAs will be partially offset.

**PRAs must be privately owned. Moreover, CED opposes proposals that the Social Security Administration hold privately invested PRA funds in its own name or in accounts for individuals.** Government trust accounts involve too great a risk of political interference with private business decisions. At the same time, we recognize that some mandated business participants and their employees as well as many self-employed do not have hands-on experience with retirement saving accounts. **Therefore, in order to protect these groups, special rules for PRAs will be needed to assure appropriate communications, prudent investment alternatives, reasonable fees, and preservation of funds for retirement.**

- In providing appropriate safeguards for PRAs, **maximum use should be made of existing regulations** governing private pensions and 401(k) and IRA saving plans (revised as needed) in order to minimize the need for new regulatory or supervisory bodies.
- To assure that PRA accounts will be used for their specific intended purpose — to provide retirement income for the full retirement years of the participant and spouse — CED favors rules applicable to PRAs that (1) **prohibit withdrawals or borrowing of PRA funds before retirement** and (2) **ensure that funds are withdrawn gradually over the life of the participant after retirement**. (This would occur, for example, if PRA fund balances were annuitized at retirement.) Employers that already manage pension funds for their employees may find it necessary to create separate “side-car” accounts for PRA contributions in order to comply with the additional restrictions applicable only to PRAs.

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\*See memorandum by JOSH S. WESTON, (page 60).



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## Chapter 2

# Basic Facts About the Social Security Retirement System

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The retirement component of Social Security (OASI) is often cited as one of the most successful social programs in the United States because it has largely achieved its primary goal — to ensure the economic security of the elderly.<sup>1</sup> The income of the elderly has grown rapidly in the postwar period, both absolutely and relative to the rest of the population, primarily due to the expansion of Social Security and private pension retirement benefits. In 1995, more than 37 million people, or 14 percent of the population, received Social Security retirement benefits, and Social Security accounted for about 40 percent of the retirement income of all retirees. The average monthly Social Security payment received by a retired worker with a nonworking spouse was \$1,030 per month in 1994. Although comparisons are difficult to make, it appears that the average retiree today has about the same total after-tax income (including non-Social Security and nonmonetary income, such as medicare benefits) as the average worker, in no small part due to Social Security and other federal social insurance programs.<sup>2</sup>

Retirees who were employed in lower-income jobs have benefited particularly from the Social Security retirement program because the benefit formula is more generous for low-income workers and they have few other sources of income. As recently as 1970, about one-quarter of elderly households had income below the poverty line. In 1995, fewer than 11 percent of elderly households were below the

poverty line, slightly lower than for the population as a whole and far below the rate for children, who are the most disadvantaged (bottom of Table 1, page 20).

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### DESCRIPTION OF PRESENT BENEFIT AND TAX FORMULAS

The Social Security retirement program is a contributory, wage-related, defined benefit plan financed entirely by dedicated federal taxes. It contains elements of pension insurance (largely unfunded) and welfare. An individual's benefits are related to past covered earnings by a complicated formula which provides larger benefits relative to earnings for lower-income workers. By comparison, the revenue source is rather simple — a flat-rate tax paid on all earned income up to a specified limit (\$62,700 in 1996). Because of the wage

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1. In the United States, the term "Social Security" generally refers to the federal retirement and disability program, more formally known as Old Age, Survivors Insurance and Disability Insurance (OASDI), which is the largest item in the federal budget. As noted in Chapter 1, the policy recommendations incorporated in this statement pertain only to the retirement component of Social Security (OASI), which accounts for about 90 percent of Social Security's expenditures; an analysis of the disability program, an important and complex topic on its own, is beyond the scope of this statement. However, because payroll tax rates are sometimes reallocated among these programs, discussions involving the financial status of the system often combine the OASI and DI trust funds.

2. For a brief review of studies on the economic status of the elderly, see *Who Will Pay For Your Retirement? The Looming Crisis* (1995), p. 34.

**Table 1****Social Security Fact Sheet**

Benefit Payments (all retirees)		Monthly Cash Payment	
Average first-year benefits, 1994, retired workers		\$747	
Average benefits, all retirees, by category, 1994			
Individual worker		671	
– without reduction for early retirement		782	
– with reduction for early retirement		630	
Couple, one earner		1030	
Spouse		359	
Survivor (widow/widower)		649	
Maximum monthly benefit in 1996 at NRA, individual		1,248	
Couple		1,872	
Minimum initial benefit in 1994 at NRA			
Individual with 30 years of contributions		519	
Couple with 30 years of contributions		780	
January 1996 cost-of-living adjustment		2.6%	
Beneficiaries (December 1995)		Number of persons	
OASI		37.5 million	
DI		5.9 million	
Total		43.4 million	
Payroll Taxes (percent)	Individual	Employer	Total
Rates			
OASDI	6.20%	6.20%	12.40%
OASI	5.26	5.26	10.52
DI	0.94	0.94	1.88
Medicare (HI)	1.45	1.45	2.90
Total	7.65	7.65	15.30
Maximum taxable earnings, 1996 (HI exempt)			\$62,700
Budget, Fiscal 1995 (billions)		OASI	OASDI
Total revenues		\$326	\$396
Total outlays		294	335
Fiscal 1995 surplus		32	60
Trust fund assets, December 1995		448	483
Retirement age in 1996			
Normal		65 years	
Early		62 years	
Benefit at age 62, as percent of normal benefit		80%	
Percent of beneficiaries with reduction for early retirement (Jan. 95)		69.6	
SSI and poverty rates			
Supplemental Security Income (SSI) (1995)			
Average SSI payment to elderly		\$250	
Maximum SSI payment to aged individual		458	
Maximum SSI payment to aged couple		687	
Number of elderly receiving SSI		1.5 million	
Percent of aged OASI recipients receiving SSI		2.1%	
Poverty income levels, 1994 (monthly income)			
Individuals, aged 65 or over		\$592	
Couples, aged 65 and over		\$747	
Poverty rates, U.S. (1993)			
Total population		15%	
Individuals under 18 years old		23	
All elderly (65 and over)		12	
Over 75		15	

base limit, the payroll tax is regressive with respect to income above this limit, but the progressivity of the benefit formula tends to counter this effect. Some basic figures about current Social Security benefit levels, tax rates, and participation are shown in Table 1.

**BENEFIT FORMULA.** The following is a simplified description of how initial retirement benefits (the payment received during the first year of retirement) are determined by the Social Security Administration. (An illustrative calculation of workers' retirement benefits is provided on page 22.) First, the worker's past covered wages are inflated by an index of historical wage growth in order to determine the present value of past earnings. From this, the average indexed monthly earnings (AIME) are determined for the 35 years of highest covered earnings. Second, a benefit rate formula is applied to the AIME to determine the primary insurance amount (PIA), the monthly benefit received by a worker retiring at age 65. The benefit formula has a progressive three-bracket rate structure. In 1995, the replacement rates were 90 percent, 32 percent, and 15 percent, applied to the following AIME brackets, respectively: \$0 to \$426; \$426 to \$2,567; and above \$2,567 (Figure 14, page 23). The dollar amounts of monthly income that define each bracket (these thresholds are known as "bend points") are adjusted annually to reflect increases in wages, as measured by an average wage index.

By relating benefits to past covered wages rather than to past contributions, the current benefit formula, which has been in effect since 1977, has two important effects. First, increases in payroll tax *rates* do not directly affect benefits, but do reduce the investment return on contributions. Second, initial benefits tend to rise in real terms because wage growth generally exceeds inflation. Indeed, as shown in Figure 15, page 23, average first-year benefits have risen rapidly in real terms and they are projected to rise further, given present benefit formulas.

Once OASDI benefit payments begin, they are increased automatically each year to reflect the rise in inflation as measured by the Consumer Price Index (CPI-U). In January 1996, for example, benefits were boosted 2.6 percent.

**ADJUSTMENT FOR EARLY OR LATE RETIREMENT.** Initial benefits are lowered for workers who retire before age 65, the current normal retirement age (NRA), and raised for those who delay retirement. The adjustment is intended to hold total lifetime benefits constant for workers retiring before, at, or after the normal retirement age. The earliest eligible age (EEA) at which a worker may receive Social Security benefits is 62 years. Workers retiring at that age receive 80 percent of the amount they would receive if they began collecting Social Security at age 65. For each year after 65 that a worker postpones retirement, initial benefits are raised by 4.5 percent, but they will soon be increased to more accurately reflect actuarial expectations.<sup>3</sup>

**ADJUSTMENT FOR WORK.** Under present law, the benefits of retirees under 70 years of age are reduced if they have earned income above a specified threshold. Specifically, in 1996, the benefits of retirees under 65 were reduced by \$1 for every \$2 of earnings above \$8,280; for retirees between the ages of 65 and 70, benefits were reduced by \$1 for every \$3 of earnings above \$12,500.<sup>4</sup> There is no benefit reduction for those age 70 and over.

The earnings test, which discourages labor force participation of older workers, was enacted at a time when it was feared that there were not enough jobs for all who wanted to work. While the analytical basis of this

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3. The adjustment for late retirement will be raised gradually by 0.5 percent every other year until it reaches 8 percent for those reaching 65 in 2008. *1994-1995 Advisory Council on Social Security Technical Panel on Trade and Issues in Retirement Saving* (September 1995), p. 9.

4. The exempt amount for workers age 65 to 70 will be increased to \$30,000 by 2002.

## ILLUSTRATIVE CALCULATION OF WORKER'S SOCIAL SECURITY RETIREMENT BENEFITS

(for workers earning one-fourth, one-half and full maximum covered wage over 35 years)

### A. Earnings History

Year	Maximum Covered Wage	Indexed Earnings <sup>a</sup>	Covered Year	Maximum Covered Wage	Indexed Earnings <sup>a</sup>	Year	Maximum Covered Wage	Indexed Earnings <sup>a</sup>
1961	\$4,800	\$27,170	1973	\$10,800	\$32,959	1985	\$39,600	\$54,454
1962	4,800	25,874	1974	13,200	38,023	1986	42,000	56,089
1963	4,800	25,255	1975	14,100	37,791	1987	43,800	54,987
1964	4,800	24,263	1976	15,300	38,360	1988	45,000	53,841
1965	4,800	23,834	1977	16,500	39,030	1989	48,000	55,243
1966	6,600	30,916	1978	17,700	38,788	1990	51,300	56,435
1967	6,600	29,285	1979	22,900	46,147	1991	53,400	56,634
1968	7,800	32,384	1980	25,900	47,879	1992	55,500	55,977
1969	7,800	30,615	1981	29,700	49,883	1993	57,600	57,600
1970	7,800	29,167	1982	32,400	51,578	1994	60,600	60,600
1971	7,800	27,772	1983	35,700	54,191	1995	61,200	61,200
1972	9,000	29,184	1984	37,800	54,193	<b>Total of Indexed Earnings</b>		<b>\$1,487,602</b>
							<b>1/2 total maximum earnings</b>	<b>\$743,801</b>
							<b>1/4 total maximum earnings</b>	<b>\$371,901</b>

### B. Calculation of Benefits

#### 1995 AIME Calculation

	Worker with Maximum wages	Worker with 1/2 Maximum	Worker with 1/4 Maximum
(1) Total indexed earnings (highest 35 years)	<b>\$1,487,602</b>	<b>\$743,801</b>	<b>\$371,901</b>
(2) Number of months (35 years)	420	420	420
(1)/(2)=AIME	<b>\$3,542</b>	<b>\$1,771</b>	<b>\$885</b>

#### 1995 PIA Calculation

Formula

90% of AIME below \$426	\$383	\$383	\$383
+ 32% of AIME between \$426 and \$2,567	685	430	147
+ 15% of AIME above \$2,567	146	0	0
= Initial monthly benefit (PIA)	<b>\$1,215</b>	<b>\$814</b>	<b>\$530</b>

#### Replacement ratios (PIA as percent of last year's average earnings)

Worker	24%	32%	42%
Worker with nonworking spouse	36%	48%	62%

#### Annual benefit

Individual	\$14,580	\$9,768	\$6,360
Couple with nonworking spouse (150% of PIA)	\$21,870	\$14,652	\$9,540

NOTE: As these calculations show, benefits are directly related to covered wages, not to contributions. Total lifetime contributions are affected by the distribution of wages over the individual's working years (and the years worked) and the payroll tax rates in effect during those years. Spouses with no earnings history receive a benefit equal to half of the worker's PIA.

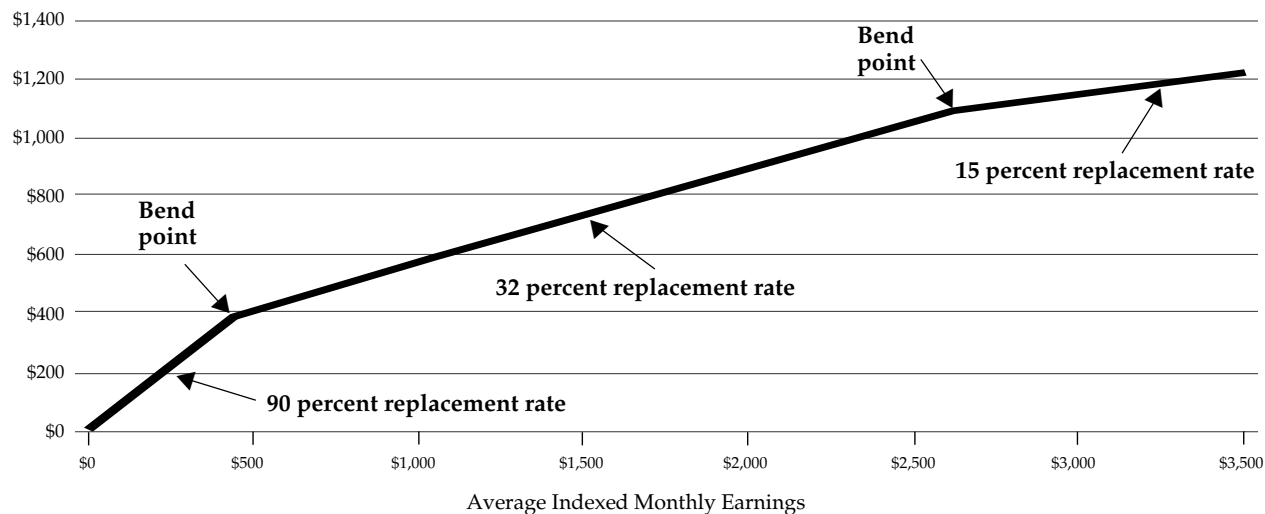
(a) Indexed earnings are wages adjusted by the average wage index except in the last three years of earnings, which use current dollars.

SOURCE: Social Security Administration, with calculations by the Committee for Economic Development.

**Figure 14**

## How the Primary Insurance Amount (PIA) Is Derived From the Average Indexed Monthly Earnings (AIME), 1996 Formulas

Primary Insurance Amount



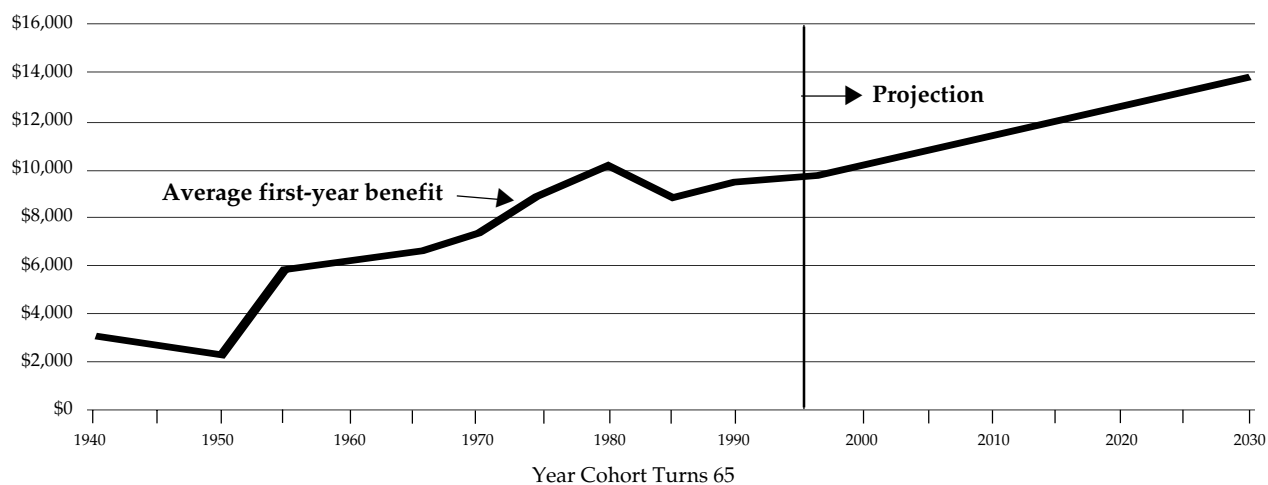
NOTE: For workers who turned age 62 in 1996, the bend points for the PIA formula are \$437 and \$2,635.

SOURCE: Congressional Budget Office.

**Figure 15**

## Average OASI Worker Benefit in First Year of Retirement

1940 to 2050 (in constant 1993 dollars)



SOURCE: Steuerle and Bakija, *Retooling Social Security for the 21st Century*, The Urban Institute. Projections based on Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1993.

assumption was questionable then, it is clear that its economic impact is now undesirable, given the expected shortage of skilled labor. Moreover, the long-run budgetary cost of eliminating the earnings test is minimal.

**SPOUSAL BENEFITS.** Spouses of workers who have reached 65 years of age and have no earnings record of their own are entitled to receive a benefit equal to 50 percent of the retired worker's initial benefit. Consequently, the combined benefit of a married worker and nonworking spouse is 150 percent of the benefit received by a single worker with the same wage and contribution history. Spouses who are eligible for benefits based on their own work record are awarded the higher of their own benefits or spousal benefits.

**SURVIVORS' BENEFITS.** Survivors' benefits are an important component of the Social Security system and are frequently ignored in discussions of the value of Social Security benefits. About 5.2 million widow(er)s and 1.9 million children received survivors' benefits in 1995. The widow(er) who starts benefits at age 65 receives an amount equal to 100 percent of the worker's benefit (PIA). Survivors' benefits are reduced if taken before age 65; a surviving spouse is eligible to receive benefits at age 60 (or earlier if caring for a child eligible for benefits), but benefits would be reduced by about 30 percent.<sup>5</sup>

**PAYROLL TAX RATES.** The combined payroll tax rate for the retirement program (OASI) is currently 10.52 percent, with 5.26 percent levied on both employers and employees. The combined retirement and disability tax rate (OASDI) is currently 12.4 percent of covered earnings, with the employer and employee each paying 6.2 percent. The self-employed pay the full 12.4 percent for OASDI. The maximum taxable wage base (\$62,700 in 1996) is adjusted automatically each year to reflect increases in the average wage index.

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## THE EARLY EVOLUTION OF THE SOCIAL SECURITY PROGRAM

In 1935, when the Social Security program was enacted by Congress at the initiative of President Franklin D. Roosevelt, it was designed to provide only retirement benefits. It was officially titled and promoted as an "insurance" program. Payroll taxes were (and still are) described as "contributions." Because eligibility for benefits depended simply on participation and age, the "welfare" label was avoided. Also critical to the acceptance and popularity of the system in the early years was the pay-as-you-go funding and the high ratio of workers to retirees that made it possible to make payments to retirees almost immediately and to keep payroll taxes low (see Table 2, page 25).

**SCRAPPING THE INSURANCE CONCEPT AND FUNDING.** If the major objective of Social Security was merely to insure people against long life, why did the founders of the system believe that government involvement was needed? Private insurance could have been developed to provide income during retirement.<sup>6</sup> Undoubtedly, paternalism was involved; some supporters wanted a mandatory system, believing that many people would fail to provide adequately for themselves and for their survivors and would become a burden on society in their old age. But perhaps the best answer is that retirement insurance was not the only objective of Social Security. A major goal of the program that could not be served easily by private insurance was to redistribute benefits to favor the poor. By contrast, the amount that individuals receive from

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5. Children (ages 18 and under) of deceased participants may receive survivors' benefits up to 75 percent of the worker's PIA. Total family survivors' benefits are limited by a maximum benefit formula.

6. Although private insurance companies did not provide retirement insurance prior to 1935, private annuities are now widely available.



Table 2

### Social Security Payroll Tax Contribution Rates

Calendar Year	Maximum Taxable Income	Contribution Rates <sup>a</sup> (percent)		
		OASDI	OASI	DI
1940	\$3,000	1.00	1.00	—
1945	3,000	1.00	1.00	—
1950	3,000	1.50	1.50	—
1955	4,200	2.00	2.00	—
1960	4,800	3.00	2.75	0.25
1965	4,800	3.63	3.75	0.25
1970	7,800	4.20	3.65	0.55
1975	14,100	4.95	4.38	0.58
1980	25,900	5.80	4.52	0.56
1985	39,600	5.70	5.20	0.50
1990	51,300	6.20	5.60	0.60
1995	61,200	6.20	5.26	0.94
1996	62,700 <sup>b</sup>	6.20	5.26	0.94

(a) Rates apply to both employer and employee.

(b) Indexed to the rate of growth in average wages.

SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds, 1995*, p. 35.

a private annuity is, on average, what they put in plus the accumulated interest.<sup>7</sup> Social Security retirement benefits have also been indexed to inflation since 1975, a feature that cannot be easily replicated by private insurance.<sup>8</sup>

Reforms passed in 1939 put Social Security on a pay-as-you-go basis, thereby permitting benefits to current retirees to be paid by taxes on current workers, rather than by drawing down assets accumulated in a fund. Pay-as-you-go financing also made it possible for early participants to receive benefits that were many times larger than could have been achieved from their limited contributions, and the high ratio of workers to retirees made it possible to raise benefits without large increases in taxes to fund them. But it is now clear that pay-as-you-go financing also made the system vulnerable to demographic change.

**EXPANDING THE SCOPE OF BENEFITS.** The original Social Security Act provided cash payments only for qualified retired industry workers age 65 or over.<sup>9</sup> Coverage has since been expanded to include virtually all workers, and new categories of benefits have been introduced. The legislation passed in 1939 also changed the character of Social Security by introducing benefits for the spouses and surviving widows of the insured as well as for other dependents (children under 18 and parents). The introduction in 1954 of disability insurance also greatly widened the scope of benefits. Over the years, numerous other legislative changes have liberalized benefits. Of course, other government programs that benefit the elderly, such as Medicare, also have been enacted since the introduction of Social Security.<sup>10</sup>

### SPENDING GROWTH AND TRUST FUND BALANCES

In the first decades of the Social Security program, total revenues greatly exceeded total outlays and the trust fund accumulated substantial reserves. But as the program matured, the total cost of Social Security benefits

7. Some have argued that one reason for government involvement is that the administrative costs per dollar of benefits are higher for private insurance than for collective insurance.

8. Private annuities can be designed to provide growth in benefits at a specified rate, not directly linked to inflation. Benefits can be linked to the stock market, but there have been sustained periods when the stock market failed to keep pace with inflation.

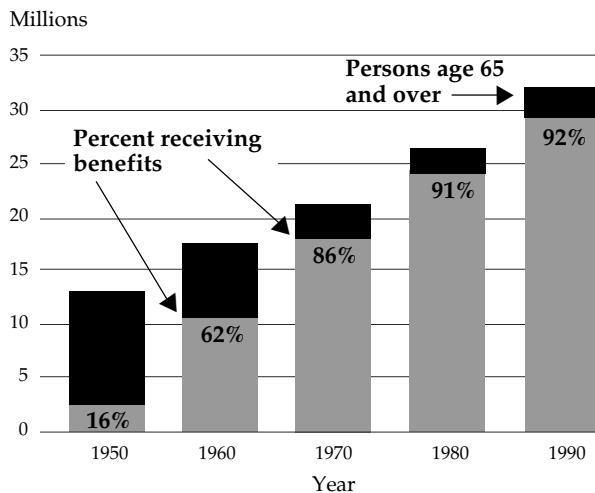
9. The first beneficiaries received lump-sum payments. Monthly benefit payments began in January 1940. Social Security Administration, *Social Security — A Brief History*, Washington, D.C.: U.S. Government Printing Office, (1995).

10. Medicare, the health program for the elderly enacted in 1965, is also partly financed by payroll taxes. Spending for Medicare is growing more rapidly than Social Security, due largely to the combined effects of rising medical costs and the demographic trends that will also affect Social Security. Medicare is facing insolvency in the near future if it is not reformed. Supplemental Security Income (SSI), a welfare program for the disabled and others, which is administered by the Social Security Administration, also provides benefits for the aged who have little or no retirement income. SSI is financed separately out of general revenues.

increased rapidly, placing substantial strain on the system. First, the share of workers eligible for benefits rose sharply (Figure 16). Second, the average life span increased, so that the proportion of workers and their spouses who lived long enough to enjoy retirement benefits rose (Figure 17), as did the average number of years spent in retirement (Figure 18). Third, legislated benefit increases and the broadening scope of benefits also contributed to the growth of spending. Some benefit increases were ostensibly intended to compensate for the impact of inflation on living standards, but because of political pressures, so-called inflation adjustments often exceeded the rise in prices. Thus, the increase in total spending reflected a rise in the number of people receiving benefits as well as an increase in the size of benefits. The number receiving OASI benefits rose from 1.3 million in 1945 to 27.5 million in 1975, while the work

**Figure 16**

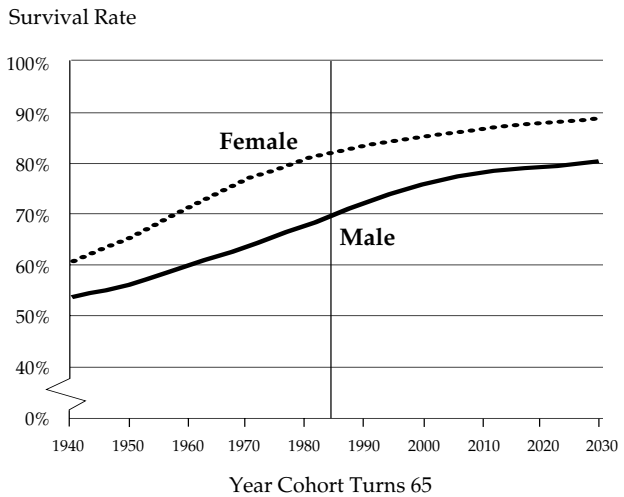
**Total Number of Persons Over Age 65 and Percentage of Those Over 65 Receiving Social Security Retirement Benefits (1950 to 1990)**



SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, pp. 123 and 147.

**Figure 17**

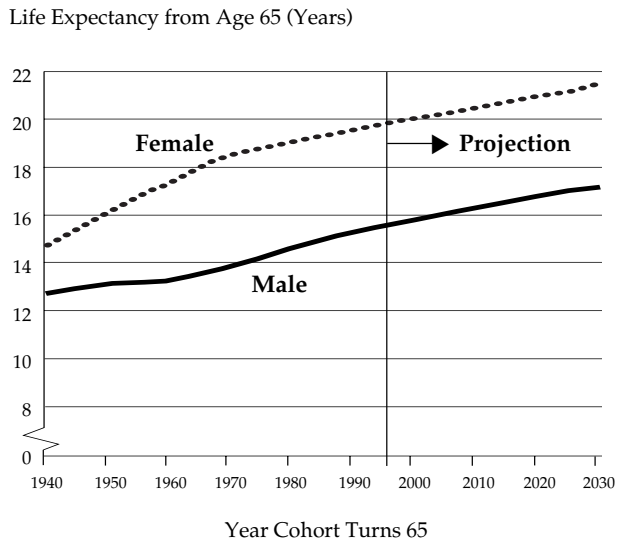
**Percent of Population Surviving from Age 21 to Age 65, 1940 to 2030**



SOURCE: Steuerle and Bakija, *Retooling Social Security for the 21st Century*.

**Figure 18**

**Projected Average Life Expectancy for Persons Aged 65, 1940 to 2030**



SOURCE: Social Security Administration, *1996 Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 61.

force rose only 116 percent. At the same time, average benefits rose more rapidly than wages. For example, real lifetime benefits for a worker retiring at age 65 in 1980 were nearly 200 percent higher than benefits received only two decades earlier while wages were up 112 percent over the same period (Figure 19).

Congress did enact some measures intended to slow the growth in total spending — such as the adoption of automatic annual cost-of-living adjustments (COLAs) beginning in 1975, which tied the adjustment to the rise in the Consumer Price Index (CPI). But these efforts were only marginally successful. Throughout this period, OASDI spending rose relative to GDP, even though its share of total government spending temporarily stopped rising in the 1960s when defense and Medicare growth accelerated (Figure 20, page 28).

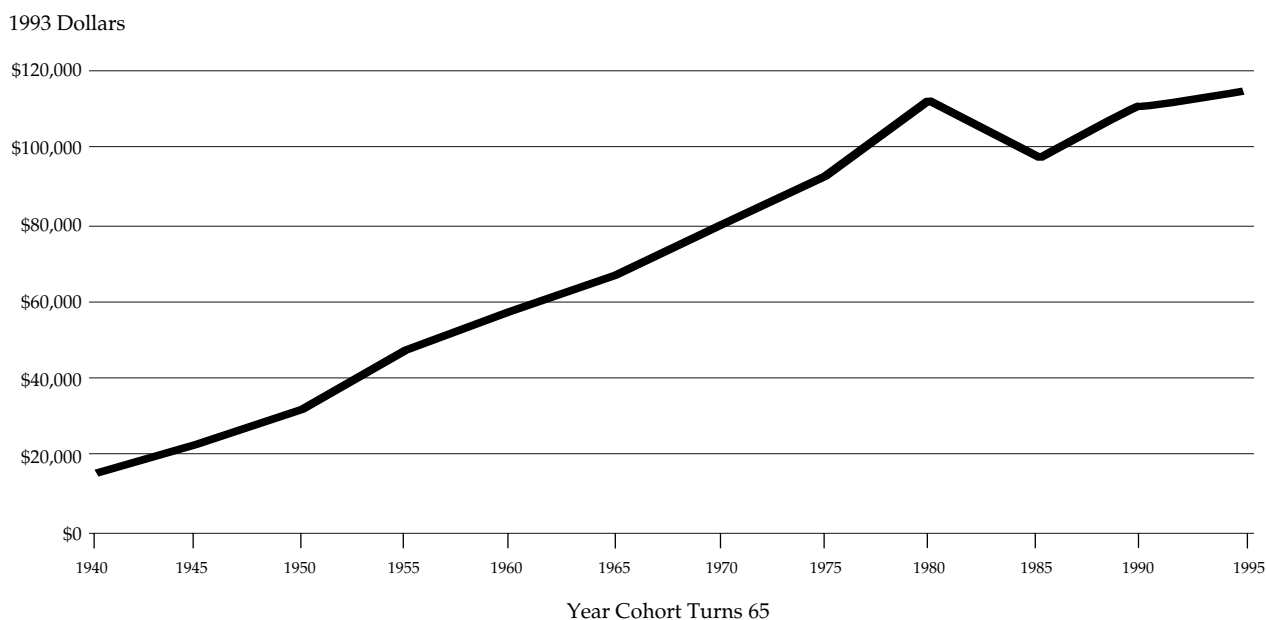
Initially, Social Security benefits were financed with a payroll tax of only one percent of the first \$3,000 of wages earned, levied on both employers and employees. But as Social Security benefits rose and the ratio of covered workers to beneficiaries declined, Congress found it necessary to raise taxes sharply to keep pace with total expenditures. From 1945 to 1980, the wage base was raised periodically and the tax rate was quadrupled (Table 2).

Despite these changes, the fiscal status of Social Security continued to deteriorate. After a decade of deficits, it became evident that significant changes would be necessary to keep the system afloat. Consequently, in 1981, a bipartisan commission chaired by Alan Greenspan was appointed to recommend a program to deal with Social Security's fiscal crisis.

**Figure 19**

## Historical Lifetime Social Security Retirement Benefits, Adjusted for Inflation

### Average Single Worker Retiring At Age 65, 1940 to 1995

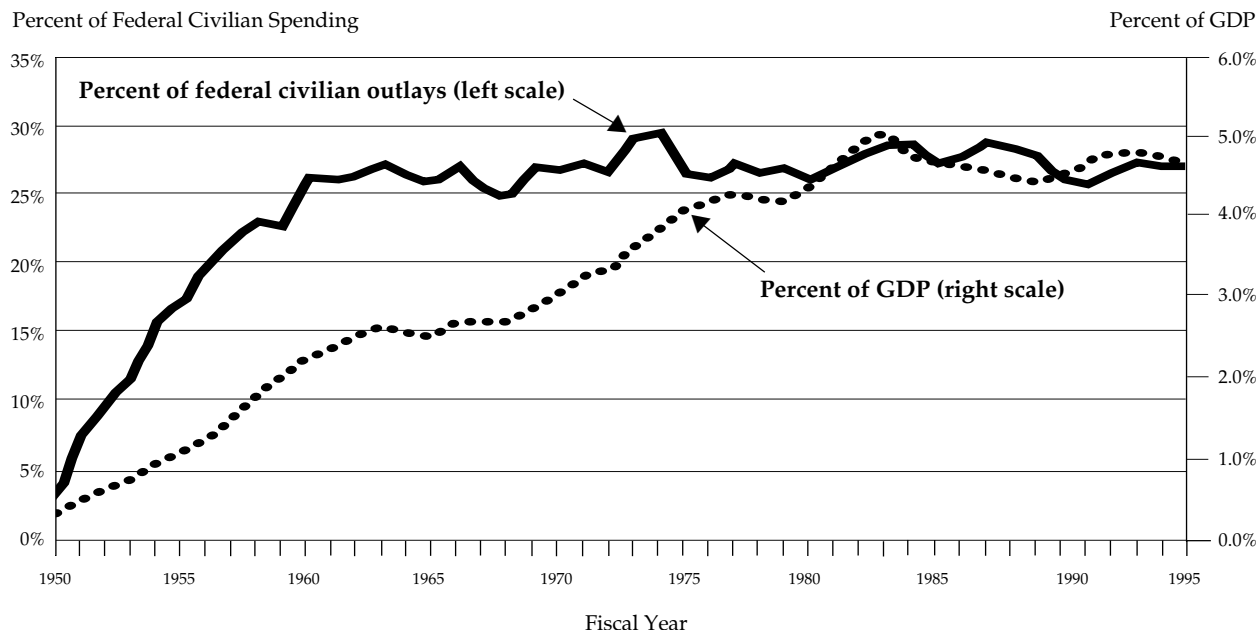


SOURCE: Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century*, The Urban Institute, 1994.

Figure 20

## Social Security Outlays, 1950 to 1995

Shown as Percentage of Total Federal Outlays and as Percentage of GDP



SOURCE: Congressional Budget Office, *Economic and Budget Outlook*, January 1995, Office of Management and Budget, *National Income and Product Accounts*, and the President's Council of Economic Advisers, *1996 Economic Report of the President*.

### THE 1983 REFORMS

Under the political cover provided by the National Commission on Social Security Reform, Congress enacted changes in 1983 that not only dealt with the immediate fiscal crisis but also attempted to address an emerging longer-run insolvency problem. Prior to the 1983 reform, actuarial projections indicated that payroll tax revenues would fall short of outlays when the baby-boom generation retired. A basic recommendation of the Commission, which was enacted into law, involved the adoption of a partially funded system on a temporary basis. The idea was to increase trust fund balances sufficiently to ensure that the baby boomers' retirement could be financed without placing an unwarranted burden on future workers. To achieve this objective, Congress legislated restraints on the growth of

spending as well as tax increases. One important change was a gradual increase in the normal retirement age (NRA) by two years, beginning in the year 2000, designed to partially offset the projected increase in the average life span. (Life expectancy has risen by 13 years since the inception of Social Security; life expectancy at age 65 has risen 4.6 years since 1940 and is now projected to rise by about three years over the next 75 years.)

### CURRENT PROJECTIONS OF INSOLVENCY

The reforms of 1983 did succeed in temporarily creating a substantial positive cash flow in the OASDI program. The operating surplus in fiscal 1995, for example, was nearly \$65 billion. The trust fund balance at the close of fiscal 1995 (\$483 billion) was nearly 1.5 times

annual outlays and rising rapidly. But the 1983 reforms failed to ensure the solvency of the Social Security system for generations to come as expected. The Social Security Administration's intermediate or "most likely" projection made in 1983 indicated that with policies then put in place, the OASDI trust fund balance would rise rapidly, reaching a peak of nearly \$21 trillion by 2045, and maintain a positive balance at least until 2063.<sup>11</sup> As it turned out, actuarial projections of OASDI trust fund balances have deteriorated sharply since 1983 (Figure 21), and now the Social Security Administration projects that the accumulating reserve will be large enough to finance only a fraction of the projected bulge in outlays. System outflows are now projected to exceed

payroll tax revenues beginning in 2010. The trust fund balances are expected to peak at less than \$3 trillion and to be completely exhausted in 2029, 34 years earlier than envisioned in 1983.<sup>12</sup>

11. Harry C. Ballantyne ASA (Chief Actuary), U.S. Department of Health and Human Services, Social Security Administration, "Long-Range Projections of Social Security Trust Fund Operations in Dollars," *Social Security Bulletin* no. 117 (October 1983): 1-4.

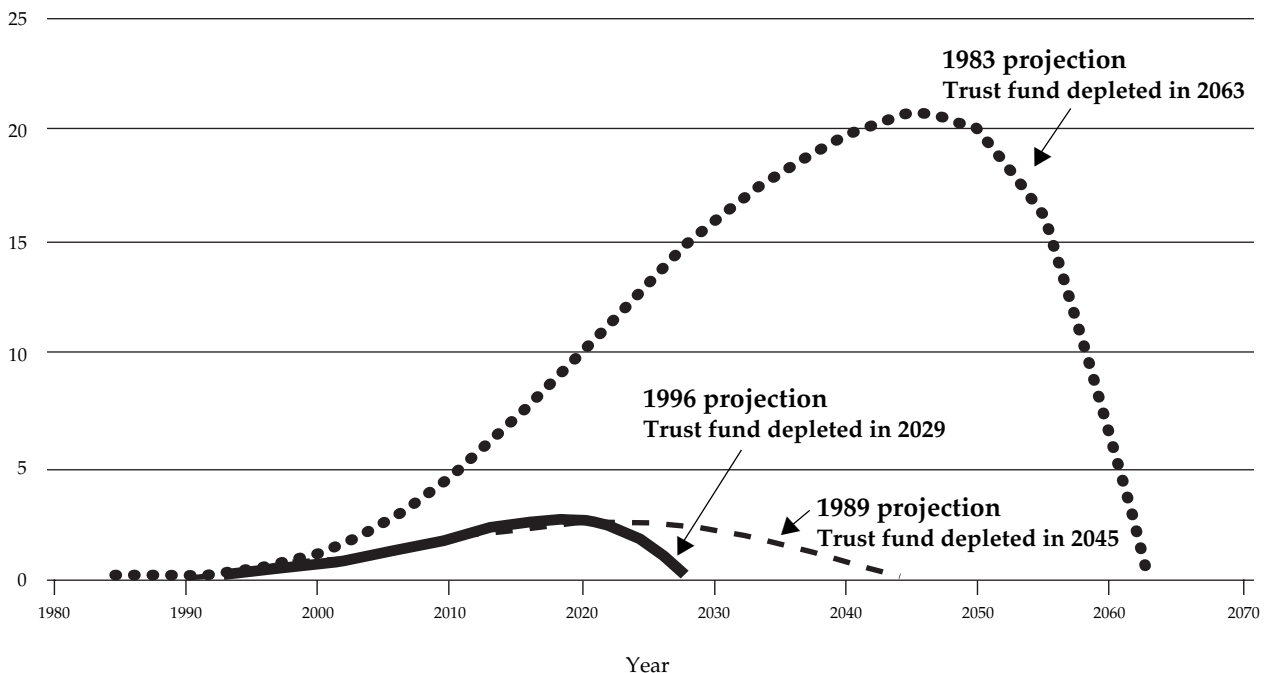
12. 1995 *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, (Washington, D.C.: U.S. Government Printing Office, 1995), pp. 26 and 172. The reasons for the deterioration in projections are complex. Economic assumptions and projection methodologies have changed significantly. Moreover, by convention, the actuarial projections are for 75 years and the demographic situation is not expected to improve at the end of that period. Thus, every year that passes, a surplus year is dropped and replaced by a deficit year in the projection.

Figure 21

## Social Security Trust Fund Projections Have Plummeted Since the 1983 Reforms

### OASDI, 1985 to 2065

Trillions of Dollars



SOURCE: Social Security Administration, *Annual Reports of the Board of Trustees of the Federal OASDI Trust Funds*, 1983, 1989, 1996.

Another way to look at the financial status of the OASDI program is to compare the present value of benefits expected to accrue to all participants (over a 75 year period) with the present value of assets and future revenues. By this measure, the actuarial deficiency in the Social Security program is about \$2.5 trillion.<sup>13</sup>

The most important factors underlying the projected insolvency of Social Security are the retirement of the baby boomers, slow growth in the labor force, and rising life expectancy (see Chapter 1). The oldest baby boomers are now 51 years old and will begin to retire in a little more than a decade. The Social Security Administration's best estimate is that the proportion of the population 65 or older will jump from about 13 percent in 2010 to nearly 20 percent in 2030 (Figure 22), largely due to the

retirement of the baby boomers. The ratio of workers to beneficiaries is expected to decline from 3.4 to 1 in 1990 to 2.0 to 1 in 2030.

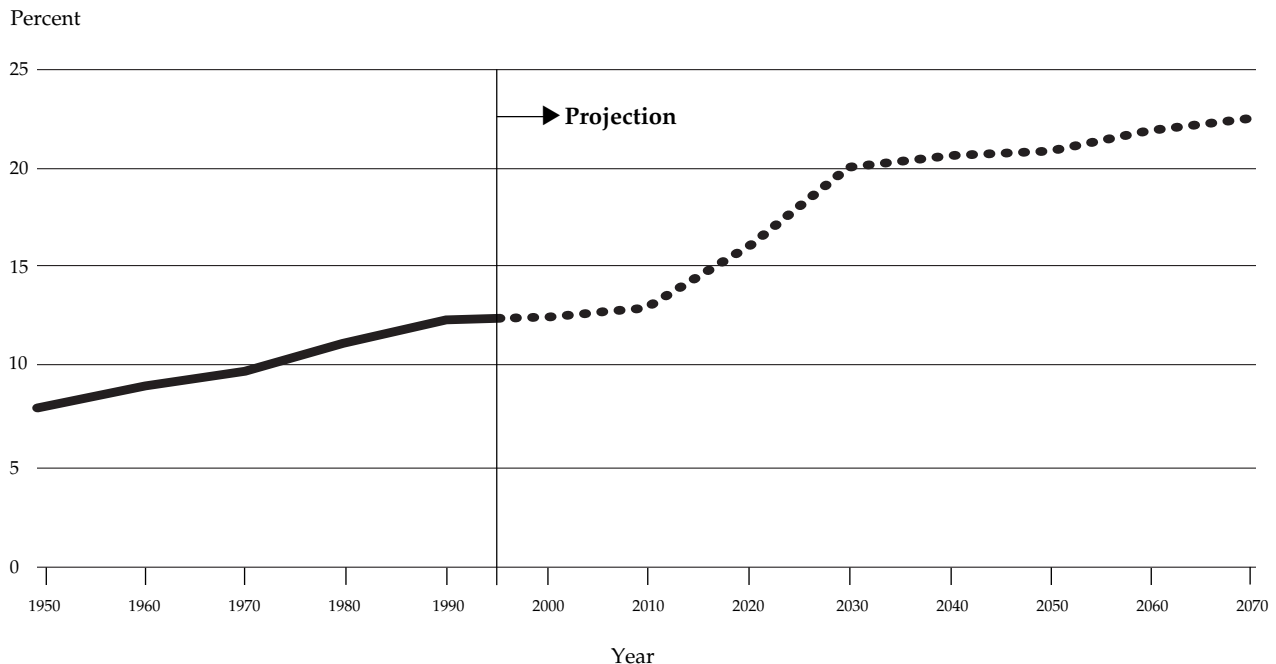
The massive revisions in past projections of Social Security funding highlight the uncertainty in demographic and economic conditions and their impact on both revenues and outlays. Because the annual revisions have repeatedly made projections more pessimistic, many have concluded that the Social Security Administration's high-cost alternative projection, in which trust fund balances are depleted much sooner, is more realistic.

It seems likely that, as the retirement of the baby boomers approaches (the oldest will be

13. *Report of the 1994-1996 Advisory Council on Social Security, Volume 1: Findings and Recommendations* (Washington, D.C.: January 1997), p. 54.

**Figure 22**

### **Persons Age 65 and Older as a Percentage of Total U.S. Population, 1950 to 2070**



SOURCE: Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1995, p. 147.



eligible for early retirement in 2008), new information will be acquired that should improve the reliability of the Social Security Administration's projections. But **CED believes that policy makers must proceed now on the basis of the available best-estimate projection that shows a huge funding deficiency early in the next century if current policies are not changed. Moreover, as a means of dealing with uncertainty in projections, CED also favors policy changes that provide a margin for error and are designed to compensate automatically for shifting economic and demographic variables.** For example, increases in the normal retirement age could be indexed to changes in life expectancy.

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## **SOCIAL SECURITY, BUDGET DEFICITS, AND SAVING**

To lighten the burden on future workers, who will have to produce all of the goods and services consumed by retirees, the growing trust fund balances need to add to national saving and investment and thereby raise productivity and the size of the economic pie that must be shared with growing numbers of retirees. But balances that are accumulating in the trust funds do not add dollar for dollar to the nation's saving and productive wealth. By law the Social Security trust fund reserves must be invested in special U.S. Treasury securities; the Treasury, in turn, may use these funds to finance government expenditures. Thus, in contrast to private securities that generally finance productive investments, Treasury securities held by the Social Security Administration may finance government's consumption. Of course, a positive cash flow in Social Security would increase national saving<sup>14</sup> if, instead of being used to finance government spending, it actually generated a *lower* total budget deficit. If Social Security surpluses lowered budget deficits, private funds would be released from federal government securities and invested elsewhere, where they could

add to the stock of productive capital (see box, page 32). But many experts believe that the trust funds are merely an accounting device used to mask the true size of the budget deficit and provide little or no real saving for the economy (see Figure 23, page 32).

Given the aging of the U.S. population, it is imperative that the Social Security operating surplus is used to reduce the federal deficit and, thereby, add to national saving. However, one possible difficulty with a goal of balancing the total budget is that, if the target is achieved, additional cuts in Social Security could lead to increased expenditures in another program or federal tax cuts and no further improvement in national saving. **CED strongly endorses the goal of achieving a balanced total federal budget by the year 2002, but we believe that this should be viewed as an interim target. We encourage political leaders to look ahead to a more difficult task of balancing the "on budget" portion of the federal budget, which does not include Social Security.** Under such circumstances, the Social Security surplus would be used to buy down the outstanding debt of the Treasury and, thereby, raise national saving.

Another reason for concern about the effects of the OASI program on saving is the apparent adverse effects of social insurance programs on private saving. If people are entitled to retirement benefits (and health care) in their old age, will this affect the level of private saving? The answer is complicated. There are some individuals who probably would not be able to retire without social insurance; given the opportunity for retirement (or earlier retirement) provided by federal health and pension programs, they may actually save more while working in order to improve their comfort in retirement. The majority of workers, however, probably view social insurance as added security that encourages earlier retirement and/or reduces the

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14. National saving is the sum of individual, corporate, and government saving or dissaving.

## SOCIAL SECURITY AND THE CURRENT BUDGET DEFICITS

The impact of the operating surplus in Social Security on saving is problematic because we do not know the answer to the counterfactual question: Would Congress spend less if Social Security was not running a surplus?<sup>a</sup> Although Social Security is officially “off budget,” the Social Security surplus continues to be relied upon to finance the projected deficit in all Congressional and Administration proposals to reduce the federal deficit as well as in proposals for a constitutional amendment to balance the budget. Congressional plans for a balanced budget in 2002 do not come close to balancing the budget without

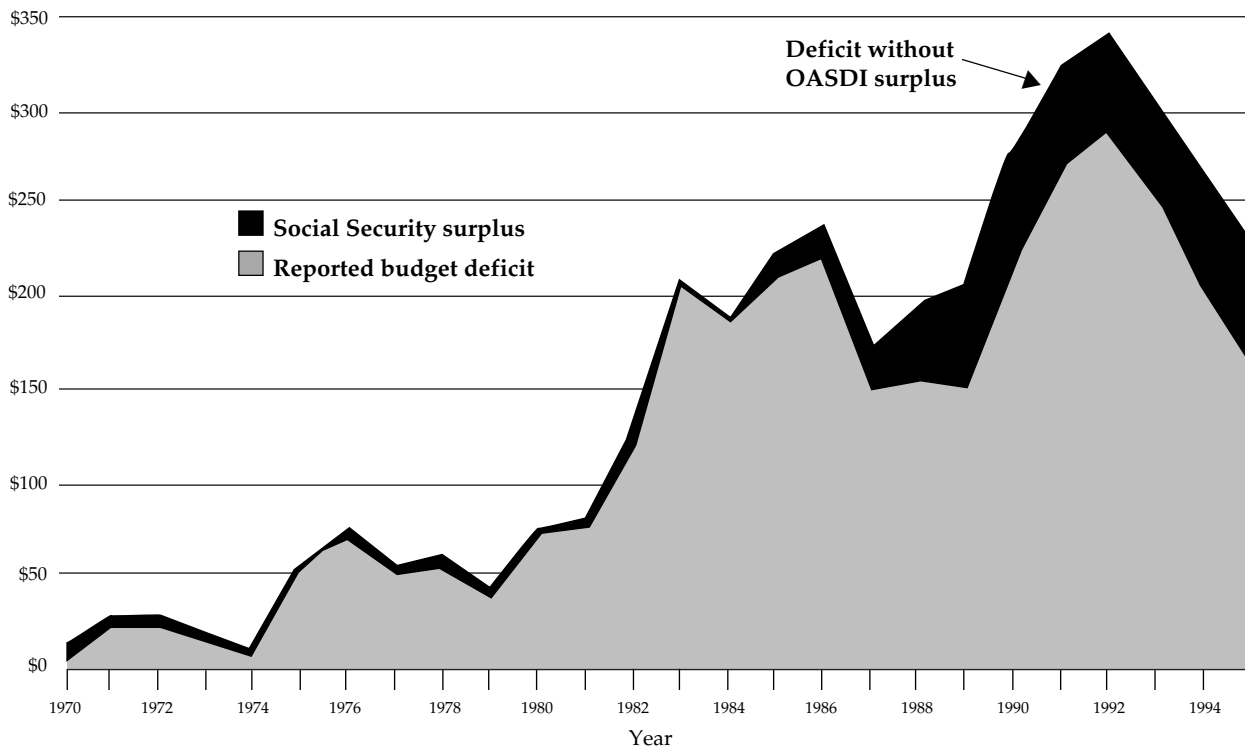
the help of the rising Social Security surplus; in that year, federal spending would have to be cut by an additional \$112 billion, or about 1 percent of GDP, to balance the budget excluding Social Security.

a Congressional budget rules applicable to Social Security and other entitlements (known as PAYGO) were intended to prevent changes in the Social Security surplus from being used to finance non-Social Security *spending*. But Congress can and does change such arrangements. This was true when Gramm-Rudman rules were in effect and also more recently. In 1993, for example, Congress dedicated a portion of taxes paid on Social Security benefits to Medicare and, in the following year, lowered the OASI payroll tax rate and raised the DI rate without affecting the total.

Figure 23

### Federal Budget Deficit and the Social Security Surplus, 1970 to 1995

Billions of Current Dollars



SOURCE: Congress of the United States, Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997-2000* Washington, D.C.: (U.S. Government Printing Office, January 1996).

necessity of saving for retirement. Indeed, while the precise magnitude of Social Security's impact on private saving is controversial, in all likelihood it is a significant disincentive for workers to save.

Thus, while Social Security undoubtedly lifts the economic well-being of millions of retirees, it may have substantial long-run adverse effects on productivity and economic growth because of its effects on both public and private saving. **Future reforms in the system should consider ways to make Social Security a positive factor in the drive to increase national saving.** (Reforms will be discussed in Chapter 3.)

## REPLACEMENT RATIOS AND BENEFIT-CONTRIBUTION RATIOS

The benefit formulas described in this chapter indicate that Social Security retirement

benefits are related directly to past covered wages, not to past contributions. The result is that if benefit formulas are not changed, "replacement ratios" (the ratio of initial benefits to final wages before retirement) are expected to remain in a fairly narrow range. As shown in Figure 24, the initial Social Security retirement benefit received by the average worker now replaces about 43 percent of a worker's final wages. Replacement rates are higher for low-income workers than for high-income workers and are also affected by marital status.<sup>15</sup>

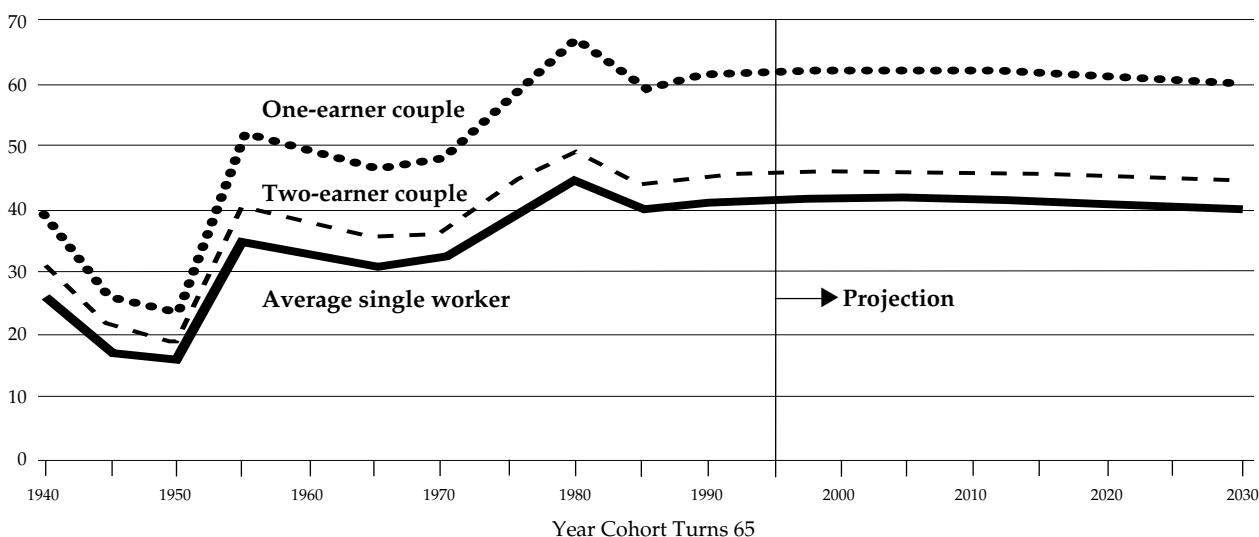
15. In 1995, Social Security replaced about 58 percent of the wages of low-income workers, and 23 percent of covered wages of high-income workers; the average replacement ratios were 45.6 percent for two-earner couples, 61.7 percent for one-earner couples and 41.1 percent for single retirees. *1995 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. (Washington, D.C.: U.S. Government Printing Office, 1995) p. 185.

Figure 24

### Replacement Ratios Have Levelled Off

Initial Benefit as a Percentage of Preretirement Income, 1940 to 2030  
(average of last three years)

Percent of Preretirement Income



SOURCE: Steuerle and Bakija, *Retooling Social Security for the 21st Century*, p. 97.

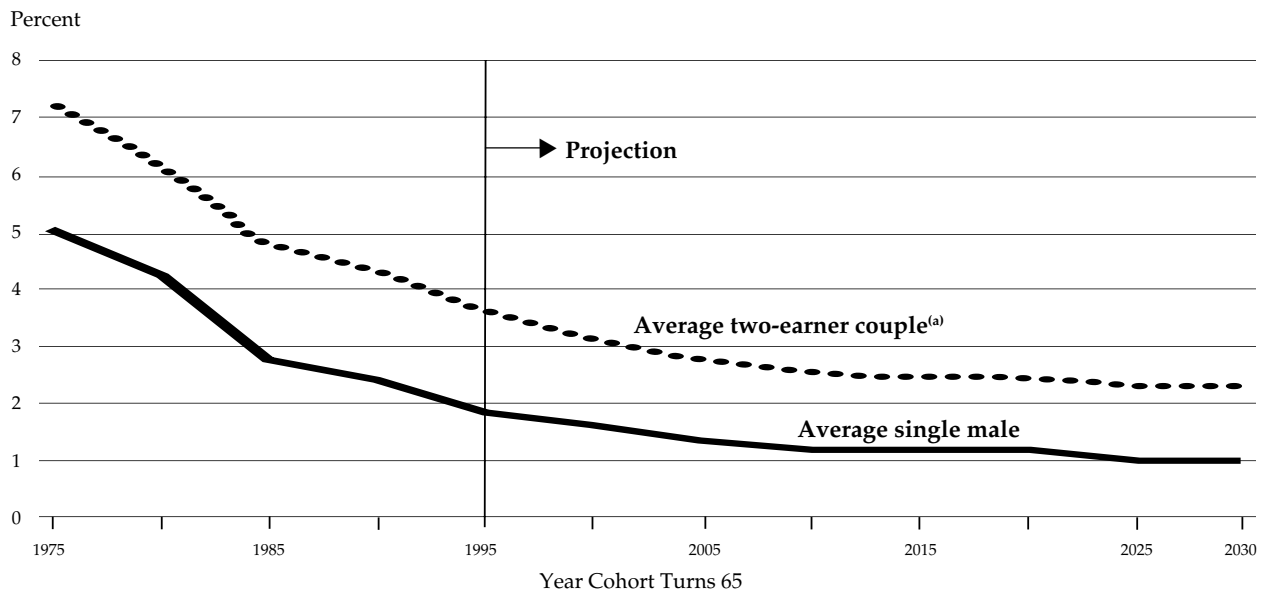
Historical data on replacement ratios over time suggest that new retirees today are about as well off *relative to their last year of earnings* as others who retired during the last decade or so. But this does not mean that recent retirees have received as “good a deal” as earlier retirees. Although recent retirees live longer and receive higher lifetime benefits, they have also contributed longer and have paid higher tax rates. Consequently, those retiring now receive less benefit per dollar contributed than those who are already receiving benefits. As shown in Figure 25, the internal rate of return on OASI taxes paid has declined sharply and will continue to decline for many years, even with no change in benefits and tax rates.<sup>16</sup>

Unfortunately, most reform measures that would improve the fiscal balance of the OASDI program, whether reduced benefits or increased payroll taxes, would necessarily reduce the return on contributions further. In Chapter 3, CED proposes reform measures that would simultaneously eliminate the Social Security system’s actuarial deficit, while raising returns on contributions for future workers.

16. Several measures are used to calculate the return on contributions. While they differ somewhat in concept and measured changes, they all show the same general trend of declining returns.

**Figure 25**

### Social Security Rates of Return Will Continue to Fall, 1975 to 2030 (OASI)



(a) Average two-earner couple has one earner with an average income history and one with a low income history (45 percent of average income).

NOTE: Internal rate of return is the interest rate on contributions that would purchase an annuity equal to projected benefits.

SOURCE: Steuerle and Bakija, *Retooling Social Security for the 21st Century*, p. 290.



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## Chapter 3

# A Program for Reforming Social Security

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The description of Social Security provided in Chapters 1 and 2 pointed out two major problems of the retirement program (OASI): The system is projected to become insolvent, and returns on contributions are falling. The analysis also pointed out that the significance of Social Security's long-term fiscal problem is magnified when considered in the broader context of the decline in national saving, the even larger fiscal problems in the Medicare program, the growth of Medicaid, and insufficient coverage and saving in private retirement programs. As public understanding of these issues grows, confidence in the ability of the Social Security system to protect the economic security of future retirees is eroding.

Political leaders are reluctant to deal with the Social Security retirement program, in part because the system is currently running a surplus and is projected to do so for at least another decade. More important, Social Security has a large and politically powerful constituency that fears change. But the demographic trends underlying the longer-run actuarial imbalance are inescapable, and the longer reforms are delayed, the more costly and disruptive the changes will be.

Unfortunately, the implementation of benefit cuts and/or tax increases designed to avoid insolvency will exacerbate the problem of falling returns. New approaches must be found to address both the actuarial imbalance and the falling return on contributions; otherwise, the Social Security system will not be supported by young people, who are already con-

cerned that the system will provide little or no benefit for them.<sup>1</sup>

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### CRITERIA FOR REFORM

The Social Security Administration's intermediate, or "best estimate," projection indicates that payroll taxes would have to be raised (or benefits cut) immediately by nearly 18 percent just to maintain the system's solvency over the next 75 years.<sup>2</sup> Larger changes would be needed if action is delayed. Satisfactorily dealing with the rate of return, or "money's-worth," problem would involve even more fundamental changes in the system.<sup>3</sup> Thus, given the magnitude and scope of needed changes, there must be agreement before reform is undertaken on the fundamental objectives of Social Security and its relation to the broader issue of national retirement policy.

The topic of national retirement policies was addressed by CED in a recent policy state-

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1. See for example, the Bozell poll conducted by KRC Research and Consulting, Aug. 10-18, 1996 as reported in *US News and World Report*, October 28, 1996, p. 68.

2. Specifically, a 2.19 percentage point increase in the OASDI tax rate, from 12.4 to 14.6, would restore fiscal balance if it were enacted immediately. See Social Security Administration, *1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: U.S. Government Printing Office, 1996), p. 129.

3. As we explained in Chapter 2, the "money's worth" concept can be measured in several ways. For example, some studies emphasize the internal rate of return, calculated as the interest rate, which, when applied to contributions, equals the present value of expected benefits. The most familiar "money's worth" concept is the number of years of benefits needed to recover all contributions.



ment, *Who Will Pay For Your Retirement? The Looming Crisis* (1995). In that statement, CED urged policy makers to give top priority to the economic security of future retirees through policies that raise national saving, especially saving for retirement. CED stated that it is incumbent upon government and business to fully fund pension commitments to their employees and to encourage increased participation in retirement programs as well as increased saving by individuals. Numerous specific changes in regulatory and tax policy were proposed to reduce the high costs of administering private retirement programs. The statement also recommended that government and business launch a massive educational program to inform workers about the need to take greater responsibility for their own retirement.<sup>4</sup> A more recent CED statement, *American Workers and Economic Change* (1996), addressed changes in labor markets, including the trend toward early retirement and large layoffs at established firms. CED urged changes in retirement policy to improve the portability of retirement assets and to encourage individual responsibility.<sup>5</sup> Reforms of Social Security should be consistent with the broad economic objectives identified in these CED statements.

Considering the important role that Social Security plays in our society, CED recommends the following criteria for evaluating proposed changes in the system.

- Social Security should provide a **minimum retirement income**, that is, a safety net, for all workers and their families.
- A fundamental objective of Social Security reform is to **increase national saving**, so that the burden of supporting rising numbers of elderly is made less onerous by more rapid capital accumulation and economic growth.
- Social Security reform should not derail

the critical economic objective of **eliminating deficits** in the federal budget.

- The Social Security benefit structure should **retain an element of income redistribution**, whereby the ratio of benefits to contributions is higher for lower-income workers.
- **Participation** in the Social Security system by workers **should be universal** because the burden of supporting the redistribution and insurance elements of Social Security should be shared as broadly as possible.
- Reform measures should be **administratively feasible**, should not raise administrative costs significantly, and every effort should be made to minimize costs arising from investments in private assets.
- Social Security reform should strive for **greater equity between generations** and for **better returns on contributions** than the present system will provide for future retirees.
- It should also seek greater **equity among current participants**, particularly between workers with nonworking spouses and other retirees.
- Reform measures should **minimize disincentives for labor force participation** by the elderly and encourage private saving.
- Changes that have a **continuing positive effect** on the system's actuarial balance and provide automatic responses to changed circumstances (such as a larger-than-anticipated increase in life expectancy) are **preferable to one-time changes** that merely postpone insolvency.
- Changes in Social Security benefits should be **enacted promptly and phased in gradually**. Workers need reasonably accurate information concerning expected Social Security income in order to make informed decisions about retirement saving and retirement age, and they require adequate

4. See *Who Will Pay For Your Retirement? The Looming Crisis*, p. 11.

5. *American Workers and Economic Change*, p. 56.

lead time to plan and adjust their behavior to any changes in the system.

Of course, no reform proposal can fully satisfy all these criteria because there are unavoidable trade-offs. For example, cuts in benefits would be likely to increase both public and private saving, but such cuts would also reduce the economic security of retirees.

Some have argued that the combination of insurance elements and income redistribution in the Social Security retirement program has made the system both inequitable and inefficient. They favor reforms that would convert Social Security into a pure retirement program in which benefits depend strictly on contributions; the current income redistribution function of Social Security would be dealt with by other government welfare programs, if at all. But as suggested by the criteria for reform described above, **CED believes that Social Security should continue to provide an adequate safety net for all participants. This requires continuation of the income redistribution characteristics of the program, which has helped to dramatically reduce poverty among the elderly.** However, this does not preclude proposals for the division of Social Security into two components: (1) a safety net that includes both redistribution and insurance against the loss of retirement income and (2) a mandatory personal retirement account (PRA), which provides retirement benefits from contributions accumulated in the account. The adoption of such a dual system would satisfy most of the reform criteria favored by CED.

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## REFORM OPTIONS

Although Congress and the Administration have been discussing reforms of entitlement programs in the health and welfare fields, some members of Congress regard the OASI retirement program, the largest of the federal entitlement programs, as the “third rail” of American politics that cannot be touched without risking political defeat. But attitudes may

be changing. In 1995, Senators Robert Kerrey and John Danforth, co-chairmen of the Bipartisan Commission on Entitlement and Tax Reform, endorsed substantial reforms in Social Security.<sup>6</sup> More recently, the quadrennial Advisory Council on Social Security, whose members include representatives from labor, business, academia, and the public, also set forth fairly radical reform options. No single proposal was supported by a majority of the members of the Council, but, for the first time, a majority did propose reforms that involve the creation of individual saving accounts.<sup>7</sup>

Most proposals for reforming Social Security can be divided into three categories: (a) changes that improve the actuarial balance of the current system, (b) reforms that deal with economic efficiency and equity within a single generation, and (c) policies that raise the rate of return on contributions and improve intergenerational equity. The priority CED attaches to proposed reforms in each category and the specific reform strategy recommended by CED are discussed in the remainder of this chapter.

### **CED’s HIGH-PRIORITY REFORMS FOR RESTORING ACTUARIAL BALANCE IN THE EXISTING PROGRAM**

According to the Social Security Administration, if no changes are made in current law, benefits could be funded at only 70 to 75 percent of current levels when trust funds are exhausted. Thus, substantial changes in present policies are needed to restore the system’s balance. **CED believes that top priority should be given to the following**

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6. Bipartisan Commission on Entitlement and Tax Reform, *Final Report to the President*, 1995. The Kerrey-Danforth proposals for the Social Security retirement program included an increase in the normal retirement age, reduced growth in initial benefits especially for upper-income workers, reduced COLAs, and the creation of personal retirement accounts. After the retirement of Senator Danforth, former Senator Alan Simpson joined Senator Kerrey in a similar proposal.

7. *Report of the 1994-1996 Advisory Council on Social Security Reform* (January 1997).

options: (1) a reduction in the growth of the primary insurance amount (PIA), the first-year benefit received by a worker retiring at the normal retirement age (NRA); (2) an increase in the number of years of employment included in the calculation of the PIA; (3) an increase in the NRA beyond that already legislated; and (4) increased taxation of Social Security benefits. Given the Social Security Administration's intermediate projections, the combined effect of these priority changes would exceed the minimum required to eliminate the 75-year actuarial imbalance in the OASDI system. As noted elsewhere, CED's objective is to maintain fiscal balance for many years beyond the projection period and to provide a cushion for possible projection errors.

**1. REDUCING THE GROWTH OF THE INITIAL BENEFIT (PIA).** The highest priority for bringing the Social Security system into actuarial balance is to slow the increase in the primary insurance amount (PIA), the initial benefit received by an individual who starts receiving benefits at the normal retirement age.<sup>8</sup> This could be done either by reducing the rate of growth of income brackets in the initial benefit formula or by reducing the benefit rates applicable to each bracket.

As explained in Chapter 2, initial Social Security benefits rise more rapidly than inflation because the PIA increases with wages, not prices. The system was designed to hold *replacement ratios* constant.<sup>9</sup> But constant replacement ratios cannot be financed in the future on a pay-as-you-go basis unless tax rates are raised sharply, because the worker-retiree ratio will fall dramatically when the baby boomers retire. **CED believes that a gradual reduction in the growth of first-year benefits — that is, a decline in replacement ratios — is far more attractive than raising payroll tax rates, especially if it is done without reducing monthly benefits for low-income individuals.** One frequently proposed approach, for example, is to adopt a formula that seeks to achieve constant *real* benefits

rather than constant replacement ratios, which could be achieved by indexing the PIA “bend points” to prices instead of wages.<sup>10</sup> This approach would lead to a large long-run reduction in costs. However, it may be more desirable to structure a PIA change in a manner that permits some growth in real benefits, especially for low-income workers.<sup>11</sup> One method proposed by some members of the Advisory Council on Social Security involves reducing the replacement ratios for the two higher-income PIA brackets. This change achieves a larger slowing in the growth of benefits for higher- than for lower-income beneficiaries.<sup>12</sup> Specifically, the 90 percent replacement rate applicable to the first threshold (the first \$426 in 1996) would be unchanged. The 32 and 15 percent benefit rates applicable to higher income levels would be reduced by 0.5 percentage points for the years 1998 to 2011 and by 1.5 percentage points for the years 2012 to 2030. Thereafter, these rates would be 22.4 and 10.5 percent, respectively. **CED believes that this method of reducing the growth in initial ben-**

8. Reducing the PIA produces a proportionate reduction in the benefit received by those who take early retirement.

9. The replacement ratio is the ratio of first-year retirement benefits to final-year income. Because increases in productivity generate real wage growth, linking PIA to wages rather than prices leads (with a lag) to increases in real benefits. This makes it difficult to fully resolve the solvency problem with increased economic growth. Moreover, even if real wages do not increase, real lifetime benefits will rise along with life expectancy if the normal retirement age is not raised.

10. “Bend points” are the points at which the replacement rates applied to the calculated average indexed monthly earnings (AIME) change. These bend points are now indexed by wage growth. In 1996, the income brackets were \$0 to \$425, \$426 to \$2,567, and amounts above \$2,567. The benefit rates (or replacement ratios) applied to each bracket are 90, 32, and 15 percent, respectively.

11. The Social Security Administration's best projection assumes that real wages will grow by 1 percent a year beginning in 2000, suggesting that the purchasing power of the average wage will rise by more than 100 percent over the 75-year projection period. Thus, if the PIA were indexed to the CPI to just maintain the real value of benefits, total spending would be considerably lower over the longer term.

12. This change is supported by the chairman of the Advisory Council (Edward Gramlich, Dean of the School of Public Policy, University of Michigan) and one other member. *Report of the 1994-1996 Advisory Council on Social Security* (January 1997).

efits is reasonable and equitable and therefore recommends its adoption. This change alone would reduce the system's 75-year actuarial deficit by about 60 percent (Table 3, page 40).

**2. INCREASING THE YEARS OF COVERED EMPLOYMENT NECESSARY TO RECEIVE FULL BENEFITS.** At present, those who have 35 qualified years can receive as large a benefit as those who work more years. CED endorses the gradual increase in the number of years of contributions included in the calculated average indexed monthly earnings (AIME) from 35 to 40 years. This change would result in a further reduction in the average PIA since years of lower or no earnings would be added to the calculation of the AIME for most workers. This change would eliminate about 20 percent of the actuarial imbalance.

**3. RAISING THE RETIREMENT AGE.** Another high-priority reform for restoring the actuarial balance of Social Security should be a gradual increase in the normal retirement age beyond that currently legislated. The scheduled increase in the NRA only partially compensates for past and expected increases in life span. Thus, as life expectancy rises beyond the scheduled increase in the NRA, current law will permit automatic increases in lifetime benefits. Considering both the past and expected future increases in life expectancy and improvements in the health of the elderly, a further increase in the NRA is widely perceived as a desirable reform. The NRA is now scheduled to rise 2 months per year from 2000 until 2005, to hold constant at 66 from 2005 until 2017, when it will begin rising again by 2 months per year until it reaches 67 in 2023. **CED prefers a continuous two-month per year rise in the NRA beginning in 2000, until it reaches 70 in the year 2030. Increases in the NRA thereafter should be linked (indexed) to changes in average life expectancy in a way that maintains a constant average ratio of working years to retirement years.** This reduction in benefits, relative to current

law, would eliminate about 44 percent of the 75-year actuarial deficit in the present program.

CED believes that an extended work life will be a necessity for most workers in the future. Nevertheless, CED does not favor an increase in the early eligible age (EEA), which is now 62 years, because some jobs are too strenuous for older workers, and such a change is likely to result in a significant increase in applications for disability benefits. Of course, benefits at early retirement should be reduced actuarially to reflect the number of years of retirement before the normal retirement age. (The actuarial adjustment would ensure that the total expected lifetime benefit is not affected by early retirement.) Those retiring at age 62 currently receive about 80 percent of the benefit at age 65. If the present actuarial adjustment is retained, whereby early retirement benefits are reduced by 6.67 percent for each year below the NRA, the penalty for early retirement at age 62 will rise as the NRA increases. When the NRA reaches 70 years, for example, the reduction in benefits would be about 50 percent. Such a large reduction in benefits for those who choose early retirement should encourage individuals to work longer or to save more to finance their early retirement.

**4. TAXING SOCIAL SECURITY BENEFITS.** Employer contributions to Social Security are a deductible expense, but individual Social Security contributions are paid from after-tax income. Consequently, taxation of *all* benefits would involve some double taxation. Social Security benefits were not subject to the federal income tax until 1983, when reforms established taxation of a portion of Social Security income. The actual percentage of benefits subject to federal income tax depends upon the income of the beneficiary. Currently, couples (individuals) with combined income<sup>13</sup>

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13. *Combined income* is the sum of adjusted gross income, non-taxable interest income, and one-half of Social Security benefits.

Table 3

### Estimated Impact of Social Security Reforms on the Actuarial Balance of the OASDI Program

	Category	Illustrative Policy Change	Reduction in 75-Year Actuarial Deficit <sup>(a)</sup>
<b>CED Priority Reforms</b>	<b>Primary Insurance Amount (PIA)</b>	<b>Reduce growth in PIA for middle- and upper-income workers.</b>	<b>60%</b>
	<b>Normal Retirement Age (NRA)</b>	<b>Increase the NRA from 65 to 70 years.</b> The NRA would be raised 2 months each year from 2000 to 2030. Index NRA to changes in life expectancy after 2030.	<b>44</b>
	<b>Years of covered employment</b>	<b>Gradually increase years of covered employment included in calculation of PIA from 35 to 40.</b>	<b>20</b>
	<b>Taxation of benefits</b>	<b>Tax all benefits above the amount of the employee's contributions.</b> This result can be approximated by counting 85% of benefits as taxable income for all taxpayers.	<b>9</b>
	<b>CPI measurement</b>	<b>Improve the accuracy of measured inflation beyond already implemented 0.21% correction.</b> (Each additional 0.1% reduction in the CPI would reduce the actuarial imbalance by approximately 6%)	<b>—</b>
<b>Total Impact of CED Priority Reforms</b>			<b>133%</b>
<b>Recommended Changes</b>	Spousal benefits	Gradually reduce spousal benefits from one-half to one-third of worker's PIA.	8
	Retiree earned income	Eliminate earned income limitations.	-5
	State/local government employees	Mandatory participation by new state/local employees.	10
<b>Reforms not supported by CED</b>	Payroll tax rate increase	Raise payroll tax rate by 1 percentage point in 1998.	40
	Cost-of-living adjustment (COLA) <sup>(b)</sup>	Arbitrarily reduce annual COLA by 0.5%.	30
	Means-test benefits	Means-test benefits for individuals with income over \$100,000	15

(a) Based on the Social Security Administration's intermediate projection, these estimates show the percentage of 75-year actuarial deficit that could be financed by each measure. In 1996, the actuarial deficit (the difference between projected revenues and income) is estimated at 2.19 percent of total payroll. However, the baseline intermediate projection shows large deficits at the end of the projection period, indicating that the tax change needed to restore solvency permanently is substantially larger. One estimate put the tax change necessary to achieve fiscal balance beyond the 75-year calculation period at around 2.5 percent of payroll.

(b) Although CED opposes arbitrary COLA adjustments, we strongly favor methodological changes that would improve the measurement of inflation.

SOURCE: *Report of the 1994-1996 Advisory Council on Social Security, Volume 1: Findings and Recommendations* (Washington, D.C.: January 1997), pp. 231-239.

below \$32,000 (\$25,000 for singles) pay no tax on benefits. Couples with income between \$32,000 and \$44,000 (\$25,000 to \$34,000 for singles) are taxed on 50 percent of benefits. Those with incomes above \$44,000 (joint) and \$34,000 (single) pay tax on 85 percent of benefits. Income tax revenues derived from Social Security benefits are currently credited to the Social Security and HI trust funds.

CED favors tax treatment of Social Security benefits similar to that for most tax-deferred private pension income. To achieve similar treatment, **CED favors the gradual phase-in of reforms that would eliminate current benefit tax thresholds and treat all Social Security benefits in excess of the contributions made by the worker as general taxable income.** This could be achieved by including about 85 percent of all social security benefits in taxable income — approximately the portion of benefit income that does not represent previously taxed individual contributions for recent retirees. As a result of this change in tax treatment, the actuarial deficit in the Social Security program would be reduced by about 9 percent.<sup>14</sup> Since low-income individuals are exempt from income taxation, they would not be affected by this change.

Most of the benefit reductions favored by CED would have no effect on those already retired. Only the taxation of benefits would affect current retirees and thereby improve equity between the current and future generation of retirees. Although means testing and arbitrary COLA reductions could also affect current retirees, CED believes that these options, as well as increases in future payroll tax rates, are less attractive options (“Options for Restoring Actuarial Balance,” page 42). Nevertheless, if the Social Security Administration’s current projections turn out to be extremely optimistic, it may be necessary to adopt some of these changes, perhaps temporarily, in order to achieve actuarial balance.

## **CED REFORMS PROVIDE A MARGIN FOR PROJECTION ERROR**

The benefit reductions in the existing system proposed by CED would be phased in slowly and affect the system’s outlays gradually, with large cumulative effects occurring at the time the system would otherwise be running out of funds. Because the annual projections of trust fund balances made by the Social Security Administration have been revised downward time and again, the CED high-priority changes are intended to exceed the minimum necessary to eliminate the 75-year actuarial deficit by about one-third. Thus, if the Social Security projections turn out to be correct, or if improvements in the measurement of the CPI significantly reduce the system’s actuarial deficiency, it may be possible at some future time to terminate the phase-in of these changes (or to reduce payroll taxes, etc.).

## **ACCURATE MEASUREMENT OF INFLATION IS IMPORTANT**

As explained in “Options for Restoring Actuarial Balance,” (page 42), CED does not regard arbitrary cost-of-living (COLA) reductions as an attractive option, because it would raise poverty rates substantially for older retirees. But COLA adjustments should accurately reflect changes in living costs. Most economists believe that the Consumer Price Index (CPI), as currently measured, significantly overstates the rise in the cost of living in the United States. A recent study indicates that the bias for years immediately ahead exceeds 1 percentage point.<sup>15</sup> Because changes

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14. *Report of the 1994-1996 Advisory Council on Social Security* (January 1997, p. 237).

15. In 1995, Congress appointed an Advisory Commission to Study the Consumer Price Index, chaired by Professor Michael Boskin of Stanford University. The findings of the commission indicate that the forward bias in the CPI measurement of the cost of living is 1.1 percent points per year, and that the implications for both federal spending and tax revenues are very substantial. Advisory Commission to Study the Consumer Price Index, *Toward a More Accurate Measure of the Cost of Living*, Final Report to the Senate Finance Committee, December 1996.



in the CPI are the basis for annual COLAs, a systematic overstatement of the CPI would exacerbate the projected insolvency of Social Security and worsen intergenerational inequity. Over time, even a small measurement

bias has a large *cumulative* impact on Social Security benefits. **CED believes that it is very important that the CPI be measured as accurately as possible. We support efforts to improve the accuracy of the CPI and believe that they should be a high priority.**

#### OPTIONS FOR RESTORING ACTUARIAL BALANCE NOT SUPPORTED BY CED

1. The impact of *means testing benefits* on the actuarial balance is potentially quite large. Means testing would spread the burden of reform more broadly among age groups, because it would reduce benefits to current retirees whose benefits, relative to contributions, greatly exceed those projected for younger participants. More important, means testing would shelter the poor from benefit cuts. But if benefits are reduced for those who prudently save for retirement, means testing will also discourage saving. Moreover, means testing would not have a large effect on total benefit payments unless it reduced the benefits of middle-income retirees, who would present strong political opposition to benefit cuts. They would argue that Social Security benefits are already progressive, providing relatively generous benefits for low-income workers. Means testing would also be difficult and expensive to administer because of the problem of determining the income of beneficiaries. Finally, means testing might reduce the support for the program by politically powerful groups.

2. *COLA reductions* could have a large effect on the actuarial balance of the OASI program, in part because benefits received by current retirees would be affected. However, Social Security is the only generally available annuity that fully protects a retiree's income from inflation and many believe that it is important for the economic security of the elderly to retain this unique feature.<sup>(a)</sup> COLA reductions would be most severe for those who live the longest and have the least opportunity to earn wages to compensate for reduced benefits.

Retirees over 75 years of age already have relatively high poverty rates, and COLA reductions would make their situation worse. To avoid such effects, COLAs could be cut only for benefits above a basic component — perhaps benefits above the poverty level of income, but this would raise administrative costs substantially.

It should be noted, however, that while we do not regard arbitrary COLA reductions as an attractive option, CED strongly favors efforts to improve the measurement of the CPI, upon which COLAs are based (see pages 41-42).

3. *Raising payroll tax rates* could have a large impact on the system's actuarial balance but, at the same time, would also have adverse effects on labor costs, employment, and on the system's progressivity. It would also magnify the problem of intergenerational inequity because it would pass the burden of restoring fiscal balance to younger workers. *Increasing the wage base* is not a very attractive alternative to raising payroll tax rates. The numbers of participants with incomes above the current maximum taxable wage are not very large, and increases in the wage base automatically trigger increases in benefits for higher-income workers.

(a) At present, the annual automatic cost-of-living adjustment is equal to the percent change in the CPI. But if the economy experiences a price shock, such as in the 1973 oil crisis, prices may rise faster than wages, which could adversely impact real incomes. Protecting the elderly from loss of income due to such price shocks is inequitable because it causes the entire burden to fall on workers and others whose income is not protected by a COLA. **A technical change recommended for the current Social Security system by CED is that COLAs should be based on the change in the CPI or a wage index, whichever is lower.**

## HIGH-PRIORITY REFORMS SHOULD BE ENACTED PROMPTLY AND PRODUCE A SUSTAINABLE FISCAL BALANCE

**TIMING CAVEATS.** Throughout this statement we have emphasized the need for prompt action to eliminate the actuarial deficiency in the Social Security retirement system. Each year that action is delayed, the cost of bringing the system into balance will rise. According to the Social Security actuaries, delay would raise the cost of restoring the 75-year actuarial balance, as follows:

Reform Starting Date	Required Increase in Payroll Tax Rate(a)	Required Annual Percent Increase in Revenues or Cut in Benefits
1996	2.19%	17.7%
2002	2.50	20.5
2012	3.12	25.5
2022	4.04	33.5

(a) Combined employer-employee tax rate. Source: Technical Panel on Trends and Issues in Retirement Saving, *Final Report to the 1994-1995 Advisory Council on Social Security*, p. 75, and *The 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds*. If the intermediate projection turns out to be optimistic, as in the past, the magnitude of future changes needed to restore balance could be even larger.

These figures indicate that the cost of delay is very high indeed. Moreover, given the magnitude of the tax increases shown above, which amount to an 18 to 33 percent increase in payroll tax revenues, **we believe that substantial cuts in benefit growth rates must be part of any reform to restore solvency. Relying solely on tax increases would be disruptive and damaging to labor and product markets. But benefit cuts must be phased in slowly so that workers have time to adjust saving and retirement plans. Thus, prompt action is necessary for any proposed reform.**

**ACHIEVING A SUSTAINABLE FISCAL BALANCE.** The payroll tax rate increases

shown in the table, left, which would be necessary to restore the system's 75-year fiscal balance, do not represent the true dimensions of the imbalance in the Social Security system, in part because the demographic situation is not expected to improve after the projection period (largely due to the fact that the average life span is expected to continue to increase). If a minimum "fix" is put in place, so that the trust fund is depleted at the end of the projection period, the system will be out of balance immediately thereafter. (The operating balance would have been in deficit for many years as the trust fund balances are run down.) Each year, as the projection is moved one year forward, a deficit year will be added to the actuarial balance and a surplus year dropped. As noted by the Advisory Council, the passage of time itself would cause the actuarial balance to deteriorate. Not many years would pass after minimum reforms were made before policy analysts would be reporting that the Social Security system needs fixing to eliminate a huge actuarial deficit. Thus, if reform measures are to have a lasting effect, the changes needed are considerably larger than shown in the table, left. That is, the immediate 2.19 percent actuarial deficit correction would have to be raised substantially to achieve permanent balance. **For this reason, CED favors reforms that make an increasing contribution to the system's solvency (such as the indexing of the NRA to life expectancy), rather than measures that only restore the 75-year balance.**

## REFORMS TO IMPROVE EFFICIENCY AND EQUITY

As a matter of economic efficiency and equity, CED also recommends the following reforms:

- **CED believes that the limitations on the earnings of retirees should be eliminated.** Benefits are currently reduced in propor-

tion to earned income above certain thresholds. (Recent proposals in Congress would raise the limit, not eliminate it.) The earnings test is very difficult to verify and is said to be one of the largest sources of error in the Social Security program. The elimination of the earnings test would have no *long-run* impact on the system's actuarial balance. More important, this adjustment would increase labor market participation of experienced and skilled workers at a time when a shortage of such workers is anticipated.

- Couples who receive both the worker's benefit and a spousal benefit under the current system often receive a much higher return on contributions than the benefit paid when both partners' benefits are based on their own contributions.<sup>16</sup> **In order to reduce the inequity between retirees with spouses who did not work or contribute to Social Security and other retirees, CED believes that the non-working spouse's benefit should be reduced gradually from one-half to one-third of the worker's benefit. CED does not propose a change in survivors' benefits (which are 100 percent of the worker's benefit for nonworking spouses).**
- **Expand Coverage to Include State and Local Employees.** The Social Security system redistributes income from high-income retirees to low-income retirees. CED favors continuation of a redistribution element in the Social Security program. However, CED believes that, as a matter of equity, the cost of redistribution must be widely shared, and, therefore, coverage should be universal. Consequently, CED recommends that all new state and local employees be required to become participants in the Social Security system, and that existing employees be permitted to join on a voluntary basis.

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## IMPROVING THE RETURN ON CONTRIBUTIONS BY INVESTING IN PRIVATE SECURITIES

The most practical approach for making the Social Security retirement program a "better deal" for future retirees is to invest contributions in private-sector financial assets.<sup>17</sup> Funds invested in corporate bonds and equities would be expected to yield a higher return than government bonds, thereby permitting a higher return on contributions. Of course, it is not likely that everyone would receive higher returns on their contributions; higher returns come with higher risk, and there will be losers as well as winners. For this reason, it is critical that the safety net provided by the existing Social Security system be preserved. Nevertheless, investments in private-sector financial assets are likely to improve the "money's worth" of contributions made by the majority of younger workers and help them achieve economic security in retirement. At the same time, investment in private securities raises a number of critical issues relating to (1) ownership and management of funds and (2) the impact on the federal budget and national saving.

## OWNERSHIP AND MANAGEMENT OF FUNDS INVESTED IN PRIVATE ASSETS

Options relating to the ownership and man-

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16. Currently, spouses with no earnings record receive payments equal to 50 percent of the worker's PIA. Consequently, the return on contributions for one-earner couples is much higher than for singles or two-earner couples who receive no such subsidy, and two-earner couples may receive smaller benefits than one-earner couples who contributed the same lifetime taxes.

17. The return on payroll tax contributions could also be improved by subsidizing Social Security from general federal revenues. But this approach would not improve intergenerational equity or raise national saving; given these considerations as well as present budgetary problems, CED does not recommend this option.

agement of investments in private-sector securities include the following:

1. Invest all or part of the balance in the Social Security's existing defined benefit plan (now invested in special Treasury issues) in private-sector financial assets owned and directed by the Social Security Trust Fund.
2. Invest additional contributions or a portion of the contributions now made to Social Security in private-sector financial assets managed and held by the Social Security Administration but credited to individuals in accounts that permit limited investment choices.
3. Permit additional contributions (or a portion of the existing contributions now made to Social Security) to be placed in privately owned and held accounts, which are invested in and limited to acceptable asset types, subject to existing regulations and appropriate additional restrictions such as requiring the preservation of funds for retirement only.
4. The same as Option 3 above, except that government supervision is more limited, similar to that for 401(k) accounts.

Options 2, 3, and 4 could also require full or partial annuitization of accumulated assets upon retirement.

Proponents of the first option believe that government ownership of private financial securities would involve low management costs (similar to costs currently experienced by the Social Security Administration) and higher returns. Those who favor the second option often cite the experience of the Federal Retirement Thrift Investment Board, which has achieved reasonable returns on privately invested federal employee retirement accounts while maintaining low management costs.<sup>18</sup> (See "The Federal Thrift Savings Plan, page 46.)

Advocates of the third option point to the highly developed and successful financial

markets in the United States as evidence of the ability of private institutions to manage these funds efficiently. For reasons described below, **CED favors Option 3 — privately owned, held, and managed accounts with the option to invest in mutual funds that hold private securities, subject to certain regulations, described later in this chapter.**

#### **GOVERNMENT OWNERSHIP AND/OR CONTROL OF PRAs IS REJECTED BY CED.**

The proposal for government ownership of Social Security trust fund assets invested in private financial instruments raises difficult questions about (a) potential political interference with private investment decisions, (b) the independence of business under government ownership, and (c) the socialization of risk.

There is a serious risk that government managers of such funds could not avoid political pressures to apply social criteria to the selection of investments. There would be political pressure to carry out government policies by directed investments even if this reduces the returns on the investments. To avoid political influence in investment decisions, some have proposed a requirement that federal government investments in private securities be limited to so-called "indexed funds," that are passively invested in a large group of securities.<sup>19</sup> But this practice would not necessarily eliminate political interference since choices among indexed funds could be influenced politically and exceptions to the requirement for indexed funds could be legislated (e.g., tobacco stocks).

With government ownership of large equity holdings, questions would arise regard-

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18. The costs of managing private investments in the Federal Thrift Savings Plan for federal employees are very low, in part because investments are limited to only three funds. (See "The Federal Thrift Savings Plan, page 46.)

19. Indexed funds typically attempt to mimic the performance of a broad index such as the Standard & Poor's 500 or the Russell 2000 by investing proportionately in the securities included in the index.

ing who would exercise stockholder voting rights. The enormous size of the Social Security trust funds could make Social Security the largest stockholder of many firms, which could lead to government influence in private industries. Government managers of such funds might feel an obligation to involve themselves in certain corporate decisions, as is the case with state-owned pension funds. But the

potential impact of federal control would be much more pervasive because state pension funds are small relative to the potential size of privately invested Social Security funds.<sup>20</sup> The

20. Under one plan advocated by members of the Advisory Council on Social Security, federal ownership of private securities is projected to approximate 7 percent of the total equity market by 2014.

## THE FEDERAL THRIFT SAVINGS PLAN: INDIVIDUAL ACCOUNT INVESTMENTS

The Federal Thrift Savings Plan (TSP) is a defined contribution retirement savings account that was established by Congress for federal employees in 1986. Participants, who receive matching funds from their respective federal agencies, have three investment options: the Government Securities Investment (G) Fund, the Common Stock Index Investment (C) Fund, and the Fixed Income Investment (F) Fund.<sup>(a)</sup> The G Fund is comprised exclusively of short-term nonmarketable U.S. Treasury securities. The C Fund is an indexed equity fund with a portfolio based on the S&P 500. The F Fund, or the U.S. Debt Index Fund, aims to match the Lehman Brothers Bond Index, which includes fixed income securities, such as government and corporate bonds, and mortgage-related assets.

The C and F Funds are managed by BZW Barclays Global Investors, N.A. Barclays was selected as the fund manager through a competitive bidding process and is subject to review by the Securities and Exchange Commission, the Department of Labor, the Federal Reserve, and the Office of the Comptroller of the Currency.

The expense ratios of all three funds are relatively low due to the size of the funds and have declined significantly as contributions have grown.<sup>(b)</sup> The C and F Fund expense ratios include TSP administrative expenses as well as management fees and trading costs. The G Fund's costs are based solely on administrative costs; this fund is not charged trading or management fees since government securities are purchased directly from the Treasury.

### Average Returns and Expense Ratios

TSP Fund	Compound Annual Rate (over life of fund) <sup>†</sup>	Expense Ratios (1995)
G Fund (government securities)	7.8%	0.09%
C Fund (S&P 500 Index)	15.0%	0.10%
F Fund (LBA Index, fixed income)	9.0%	0.11%
Compound annual inflation rate (CPI)	3.6%	

<sup>†</sup> These figures are for January 1988 through December 1995. The C and F Funds' first investments took place in January 1988. The first G Fund investment was in April 1987.

SOURCE: Federal Retirement Thrift Investment Board, *Guide to TSP Investments* (Washington, D.C.: May 1996), and *Summary of the Thrift Savings Plan for Federal Employees* (July 1995).

(a) The first 3 percent of contributions is matched 100 percent, the next 2 percent is matched 50 percent. The limit on contributions for FERS employees is the lesser of 10 percent or \$9,500. For CSRS employees (those hired before 1985 who chose to remain in the old defined benefit plan), the limit is a 5 percent contribution.

(b) TSP funds in the Barclays C Fund were \$11.5 billion, with the total fund holding \$41.5 billion. The TSP holds \$2.2 billion of a total \$12.2 billion in the Barclays F Fund. The G Fund held \$22.4 billion in assets in May 1996.

possibility of federal government influence on private firms, through its large holding of publicly held private financial resources, is an unnecessary and undesirable risk for the U.S. economy.

Another issue involves the distribution of risk. If private securities were owned by government on behalf of investors, losses would tend to be “socialized” — that is, forced on taxpayers. By contrast, if the funds were privately owned, individuals would have the opportunity to choose (within some limits) the level of risk that they find acceptable.<sup>21</sup>

Not only does CED oppose government ownership of private securities, **we also believe that the proposal for government to hold and control private financial securities in the name of individuals is not an appropriate option.** Even if such financial assets are credited to the accounts of individuals, it would be difficult to insulate them from government influence or budgetary juggling. One example was provided in late 1995 when Congress refused to raise the federal debt limit and Treasury Secretary Robert Rubin delayed interest payments and withdrew funds from the individual accounts of federal employees to avoid default on the nation’s debt.<sup>22</sup>

**CED prefers the creation of personal retirement accounts (PRAs), owned by (or attributed to) individuals, held privately, and invested in financial assets selected by individuals, subject to regulations described in the “Summary of Recommendations,” pages 16-18.** Undoubtedly many would choose to hold a portion of their funds in equities. It is likely that such accumulated funds, annuitized and withdrawn only at retirement, would provide higher retirement income than investments in government securities exclusively.<sup>23</sup> Young workers, who believe that government will not keep its promises with respect to Social Security benefits, could feel more confident about their economic security if they have a PRA account because they would own the funds.

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## SAFETY NET AND DEFICIT CONSIDERATIONS FAVOR AN “ADD-ON” ACCOUNT RATHER THAN “PRIVATIZATION” OF SOCIAL SECURITY

Some have proposed converting the Social Security retirement program into a private retirement program by placing existing payroll tax revenues into private accounts, similar to PRAs. CED opposes such “privatization” of Social Security because a private program could not easily provide all the “safety net” features of Social Security that are necessary to protect the poor. The unique features of Social Security include redistribution from higher- to low-income workers and inflation indexation of basic benefits. Moreover, existing payroll tax revenues will be needed for some time to finance benefits for current retirees and older workers under the current system.

Even partial privatization — that is, diverting a significant portion of existing payroll tax revenues to private accounts — would raise serious problems. If PRAs are financed by “carving out” a substantial portion of the

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21. Some also question the ability of government managers to attain market returns consistently. The massive investments made by Social Security would be highly visible, and decision variables concerning purchases and sales would be known from easily available data. As a result, securities markets would be able to anticipate buying and selling, which would tend to bid the price up or down beforehand. The Social Security Administration would buy at higher prices and sell at lower prices than smaller, less visible groups, thereby reducing expected returns. See Lawrence J. White, *Investing the Assets of the Social Security Trust Funds in Equity Securities: An Analysis*. The Investment Company Institute, May 1996, p. 12.

22. In November and December 1995, the Treasury shifted federal pension assets into cash and later withheld interest due the civil service retirement fund. Funds were withdrawn from the employees’ defined contribution fund (the so-called “G Fund”). *Wall Street Journal*, December 13, 1995, p. A2.

23. The real return on equities has exceeded the return on government bonds by about 4.7 percent during the past century according to estimates made for the Advisory Council on Social Security. However, there have been periods of about a decade when returns on equities did not exceed the return on bonds, and there is no guarantee that such a large differential will be realized in the future.



present payroll tax and benefits under the existing system are maintained, the budget deficit would rise massively. If, for example, half of FY1995 OASI payroll taxes had been diverted to PRAs and no other action were taken, the total federal deficit, as conventionally measured, would have nearly doubled.<sup>24</sup> Thus, under a “carve out” system, national saving would not rise unless other taxes are increased (or spending cut) to pay for the benefits of older participants under the existing program.

Many proposals for “carve-out” systems actually do include an additional tax, combined with a large increase in the budget deficit, to finance benefits under the old system. (In some cases, the tax increase is left in place long after the transition so that the additional debt can eventually be retired. Of course, it may be politically difficult or impossible to achieve and to maintain these taxes.) Using debt this way to fund continuing obligations would impose a huge burden on future generations. To avoid the appearance of annual federal deficits, some have proposed that debt financing take the form of “recognition bonds” issued to participants in the existing system. But this mechanism would not reduce the future burden; recognition bonds would still be redeemed when holders of these bonds retire, and at that time, the Treasury would still have to raise taxes, cut spending, or issue new debt.

Of course, it can be argued that the increase in private saving resulting from PRA accounts would ease the problem of financing future budget deficits, and that any increase in the Treasury’s debt resulting from diverting payroll taxes to PRAs simply reveals the true size of the future liability. **However, there is a tangible difference between government debt and the government’s liability for future Social Security benefits: Future Social Security benefits can be, and frequently are, changed by legislation, as recommended in this report.** For example, in 1983, Congress reduced future liabilities substantially by increasing the normal retirement age for future retirees. Often, small program changes can

have a large cumulative effect on liabilities. **By comparison, federal bonds (which would include “recognition bonds”) are a contractual debt obligation that cannot be legislated away without very serious consequences.** If present projections prove to be optimistic and benefit cuts are called for in the future, the existence of a contractual obligation in the form of “recognition bonds” would tie the hands of future policy makers. Moreover, in contrast to a potential liability, publicly held federal debt must be financed by credit markets, which has direct implications for competing credit demands. Interest costs resulting from a large increase in the debt would, by themselves, be an enormous burden, placing severe limitations on federal budget policy.

In our view, the adverse budgetary consequences of employing a “carve out” approach to finance private accounts are inescapable. **Thus, CED prefers the “add-on” approach, whereby the PRA system is an addition to a solvent defined benefit system financed by the current payroll tax.** Although contributions to PRAs would receive favorable tax treatment, there is no reason to expect that budget deficits would be affected in a substantial way by the creation of PRAs, because they do not divert existing payroll taxes. With an add-on system, the existing payroll tax would be available to pay for the benefits of current retirees and older participants. **But if policy makers prefer to divert present payroll taxes to finance PRAs, we believe that it is imperative that such proposals be accompanied by specific recommendations for contemporaneous federal spending cuts and/or tax increases to ensure that a rise in the budget deficit (government dissaving) does not offset the increase in private saving.**

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24. The federal budget deficit in FY1995 was \$164 billion. The OASI payroll tax revenues amounted to \$289 billion, which together with interest (and other) income yielded \$326 billion of income. Cash outgo amounted to \$294 billion, leaving a surplus of \$32 billion. If half of payroll tax revenues (\$145 billion) had been diverted to private accounts, the federal deficit would have been about \$309 billion, excluding increased interest costs.

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## THE IMPACT OF THE TWO-TIER SYSTEM ON SAVING

An important advantage of the two-tier system is that it would generate an increase in national saving. Why would saving rise? To begin with, by making the existing program solvent, future federal deficits would be substantially smaller, thereby raising national saving. PRAs will also generate new saving. Of course, to the extent that individuals and businesses substitute PRAs for other saving, by shifting saving from other financial instruments or by reducing contributions to private pensions and 401(k)s, for example, there would be no increase in private saving. Nor would the shifting of pension funds from Treasury bonds to private securities by itself raise saving.<sup>25</sup> However, we believe that PRAs would increase private and national saving substantially, if certain conditions are met: (1) contributions to PRA accounts must be mandatory; (2) access to these funds must be limited to retirement purposes only, and accumulated funds must not be available as collateral for loans; and (3) the federal deficit must not rise substantially due to the design of PRAs.

PRAs must be mandatory in order to ensure an increase in national saving. A large number of workers, who currently have little or no savings and are not already contributing to pension funds, would have no choice but to reduce consumption and increase saving. Many others have very small savings and, therefore, they would soon run out of funds to shift into PRAs. The requirement that the funds be tied up until retirement would result in large accumulations, and the preclusion of their use as collateral for loans would provide a substantial boost to saving. It is hoped that compulsory saving would introduce workers to the habit of saving and a greater understanding of investments and, thereby, encourage them to save beyond the minimal required amount.

As noted in Chapter 2, many economists believe that the unfunded Social Security

system discourages private saving. If so, decreased reliance on the defined benefit component of Social Security for retirement income may raise saving.<sup>26</sup> The reduced reliance on the traditional Social Security program may also encourage increased saving by government. Unlike the Social Security surplus, the funds placed in privately owned accounts would not be available to government to finance spending.

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## THE CED PROPOSAL

**CED favors a Social Security retirement system that continues to protect the basic economic security of all retirees, but which also is actuarially sound, encourages saving, and offers an opportunity for future retirees to receive a reasonable return on their contributions.** To achieve this, two changes are necessary. First, the high-priority reforms recommended by CED to restore the solvency of the existing defined benefit system (such as the reduction in the growth of the PIA and the increase in the NRA) must be enacted promptly. Second, supplementary mandatory contributions to a personal retirement account (PRA) must be instituted. With these changes, the present program will evolve into a two-tier system comprised of (a) a solvent defined benefit program, which is less generous to middle and upper income retirees, but at the same time provides an acceptable basic economic safety net for all participants, and (b) a new defined contribution plan (PRA) that offers an opportunity for higher returns on contributions.

**THE BASIC DEFINED BENEFIT SYSTEM.** For the foreseeable future, the defined benefit component of Social Security would

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25. Although a reduction in funds available to government and an increase in funds available to private investors would not directly affect national saving, it could affect the relative yield on private and government investments.

26. Although many economists believe that Social Security reduces saving, there is considerable disagreement and uncertainty about the size of the impact.

be financed entirely by payroll taxes at their existing rates. In the long run, however, it may be possible to lower payroll tax rates once the reforms proposed by CED have eliminated the system's fiscal imbalance. The reduction in the growth of the PIA, the increase in the NRA, and other changes described earlier would restore the actuarial balance of the existing system by gradually slowing the growth of outlays. The basic benefit would be both an assurance of at least a minimum income in retirement and a mechanism for redistributing income. For long-time lower-income participants, there would be no reduction in replacement rates at the normal retirement age, because benefits would continue to rise with incomes. The differential between benefits for high-income and low-income recipients would be reduced significantly compared to the current situation.

The major characteristics of the reformed basic defined benefit system would be as follows:

- The defined benefit program would retain most of its present characteristics: The payroll tax would remain unchanged and benefits would be similar to the present system, though the growth of benefits would slow, for upper- and middle-income individuals, and the age and work requirements to receive full benefits would be raised.
- Even for upper- and middle-income participants, real first-year benefits are not expected to decline, assuming that they are long-term workers who retire at the normal age. Basic benefits for a low-wage worker will continue to grow in real terms and would be at least 80 to 90 percent of the poverty income level. The combination of the basic benefit and PRAs would raise income above the poverty level for low-income, long-time contributors.
- As is true now, the basic benefit, once drawn, would be fully indexed for infla-

tion to ensure that it does not lose value in real terms, thereby preventing the real income of retirees from falling as they become older. (Of course, COLAs should be based on accurately measured changes in the cost of living.)

Spousal benefits, but not survivors benefits, under the defined benefit plan would be reduced gradually from 50 to 33 percent of PIA in order to improve equity between workers and nonworkers.

Payroll tax rates would remain at present levels at least until projected Social Security tax revenues and trust fund balances exceed the amount needed to finance benefits under the reformed basic program. **If current long-run projections are correct, the reforms favored by CED would be more than sufficient to restore actuarial balance. Eventually, policy makers would have the option of reducing payroll taxes or raising basic benefits (halting the phase-in of further benefit cuts). However, given the uncertainty in the outlook, implementation of such changes should be delayed.** If, after a few decades of experience, it is determined that this projection will be realized, policy makers could then exercise this option.

The trust fund balance in the basic defined benefit system would remain invested in special Treasury issues. But to ensure that the annual surplus is not used to finance government spending, **federal deficit targets should gradually be changed to exclude the Social Security surplus.**

A more detailed description of the specific reform measures included in the CED proposal is provided in the Summary of Recommendations, pages 16-18.

**THE PERSONAL RETIREMENT ACCOUNT (PRA).** The personal retirement account proposed by CED would be a private defined contribution plan. PRA accounts would be owned by or attributed to individual participants. **Contributions could be invested**

**in a limited number of private broad-based financial funds.** Benefits would be paid from funds accumulated over the retiree's lifetime. PRAs would be funded by mandatory contributions amounting to 3.0 percent of covered wages, with 1.5 percent paid by both the employee and employer. Though contributions to PRAs would be mandatory, they would not be properly classified as a tax because they would not affect federal revenues or outlays directly.

For a variety of reasons, some additional government regulation of personal retirement savings accounts would be required:

- In providing appropriate safeguards for PRAs, while minimizing the need for new regulations, maximum use should be made of existing ERISA regulations governing private pensions, 401(k) and IRA saving plans, revised as needed.
- To assure that PRA accounts will be used for their specific intended purpose — namely, to provide retirement income for the full retirement years of the participant and spouse — CED favors rules applicable to PRAs that (1) prohibit withdrawals or borrowing of PRA funds before retirement and (2) ensure that funds are withdrawn gradually over the life of the participant after retirement. (This would occur, for example, if PRA fund balances were annuitized at retirement.)
- Because contributions to PRAs would be mandatory, even for low-income and part-time workers, many accounts would have low balances and would be owned by individuals with little experience in investments. Consequently, regulatory authorities must be concerned about the administrative feasibility and costs associated with individual accounts, as well as the quality of investments in individual accounts. One approach would be to limit investment choices to specific mutual funds, at least until participants gain more experience. However, investment choices must be

broad enough to minimize possible distorting effects in capital markets.

- For employers who now manage pension funds for their employees, it may be necessary to create separate “side-car” accounts for PRA contributions in order to comply with the additional restrictions applicable to PRAs.

Contributions to PRAs would receive tax treatment similar to 401(k)s. These mandatory contributions would not limit in any way the level of tax preference currently available to many voluntary retirement saving programs.

**IMPROVED SECURITY FOR WORKERS WITHOUT PENSIONS.** An important aspect of the CED program is that it would provide greater economic security for part-time or contingent workers and others who do not have access to a private pension. Like the basic defined benefit plan, PRAs would be fully *portable*. All funds contributed to PRAs by employers and employees would be immediately and fully *vested* in individual accounts.

**IMPACT OF PRAs ON EMPLOYER COSTS AND ON THE SELF-EMPLOYED.** Although contributions to PRAs are technically not a tax, the 1.5 percent employer contribution to PRAs mandated by the plan would raise labor costs for some firms. However, those that already contribute to pension plans might choose to substitute contributions to PRAs for existing contributions to 401(k)s or other plans, and in such cases, there would be no significant increase in costs (and, as noted earlier, no increase in retirement saving). **But the employer contribution to PRAs could constitute an additional labor cost:** (1) if existing labor contracts prevent shifting of pension funds to PRAs, (2) if the employer does not have a pension plan for employees, and (3) if the employer hires part-time or contingent workers who are not eligible for company pensions. Likewise, the self-employed would bear the burden of the entire 3.0 percent contribution to PRAs. **Of course, many will welcome**

**the opportunity to shelter additional income in tax-deferred accounts.**

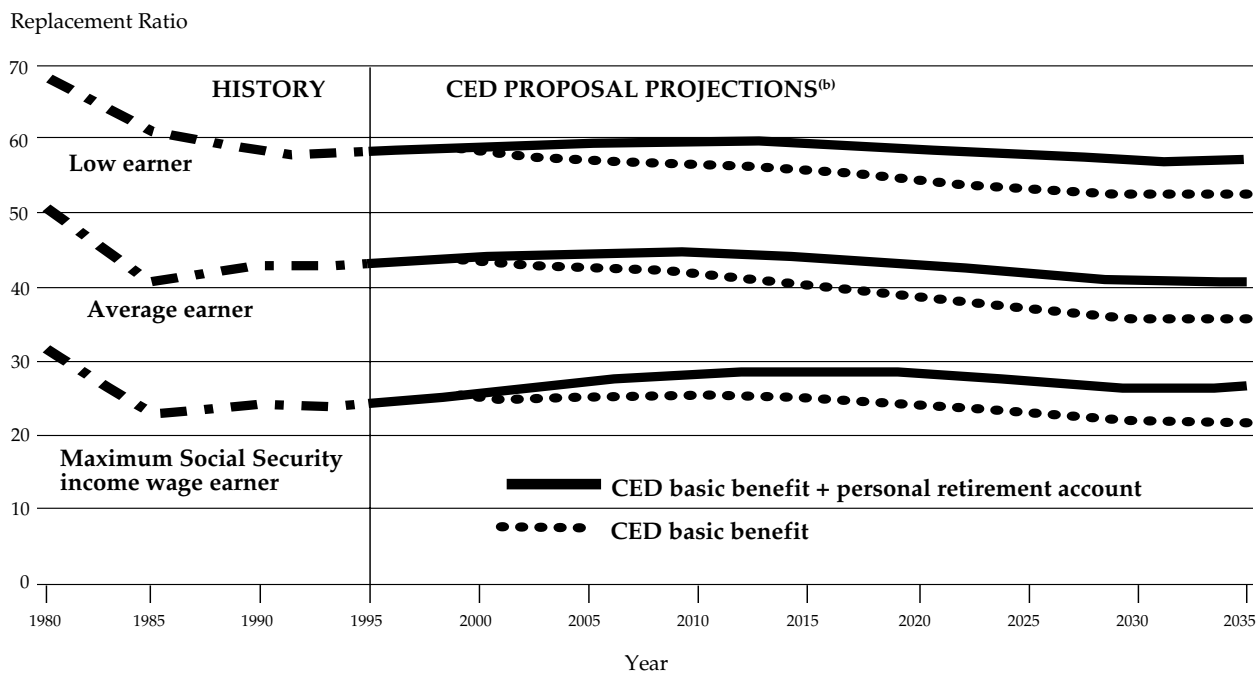
**ADEQUACY OF BENEFITS.** Over the years, as the basic benefit grows more slowly for upper- and middle-income retirees, PRA balances would rise, permitting participants to replace lost benefits. It is estimated that the required annuity from PRAs *combined* with the basic benefits from the reformed defined benefit plan would provide all retirees who worked long enough to receive the full basic benefit (including minimum-wage workers)

with a combined retirement income well above the poverty level, even assuming that the PRA funds are invested conservatively. As shown in Figure 26, even if all of the benefit cuts identified by CED were implemented, the combined system would provide replacement rates at the normal retirement age that are greater than or equal to the benefits promised by the current insolvent system, which cannot be paid in full with projected revenues. Young workers would receive a higher return on their total contributions under this dual system than if the old regime were made

**Figure 26**

### Replacement Ratios with CED Reform Proposal

**Initial-Year Retirement Benefits<sup>(a)</sup> at NRA, Three Wage Profiles, Percent of Last Year's Earnings, 1980 to 2035<sup>(b)</sup>**



(a) The ratio of future benefits to taxes could be significantly higher than indicated in the graph, because the CED proposal incorporates a considerable margin for error. If current projections do not deteriorate significantly, it will not be necessary to fully phase-in all the spending cuts proposed by CED. The CED PRA investment return assumes an average investment portfolio of 60 percent in fixed assets at a real rate of return of 2.3 percent, and 40 percent invested in private equities with a real return of 7.0 percent, for a combined real rate of return on the account of 4.175 percent.

(b) Male retiree with steady lifetime earnings.

SOURCE: Office of the Actuary, Social Security Administration with calculations by CED.

solvent by increases in payroll taxes (Figure 27).

CED believes that the broader economic consequences of this program would be highly advantageous. For most workers, the contributions to PRAs would provide a substantial new source of retirement income and saving. In 1995, for example, a contribution amounting to 3 percent of covered payroll would have amounted to \$88 billion, about 1.5 percent of personal income.<sup>27</sup> Of course, as explained earlier, not all of this contribution would represent new private saving. Moreover, because

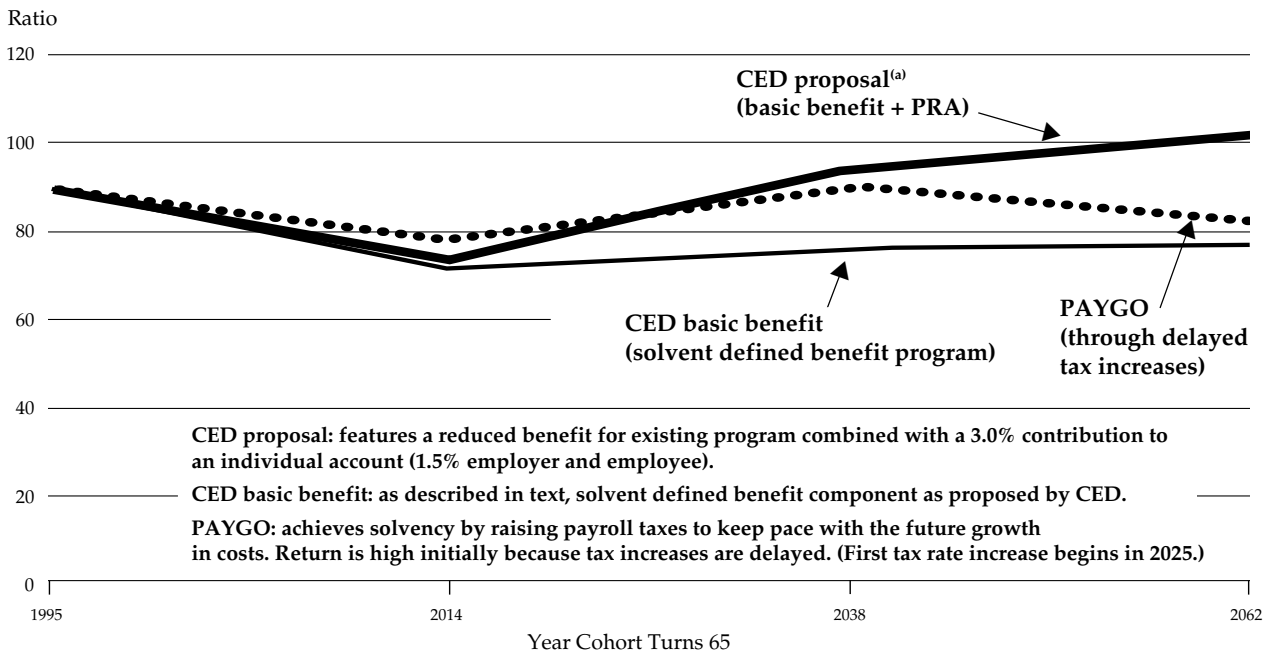
individual contributions to PRAs receive a tax preference and business contributions would be a deductible cost, there would be some reduction in federal tax revenues. But overall, the program would generate a substantial increase in national saving.

In sum, the reformed system recommended by CED would achieve several desirable objectives:

27. U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, (June 1996); and Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds*, 1996, p. 176.

Figure 27

### Ratio of Benefits to Taxes (in Present Value) Under CED Proposal Composite Worker, Average Steady Earner, 1995 to 2062



(a) The ratio of future benefits to taxes could be significantly higher than indicated in the graph because the CED proposal incorporates a considerable margin for error. If current projections do not deteriorate significantly, it will not be necessary to fully phase-in all the spending cuts proposed by CED. The CED PRA investment return assumes an average investment portfolio of 60 percent in fixed assets at a real rate of return of 2.3 percent, and 40 percent invested in private equities with a real return of 7.0 percent real, for a combined real rate of return on the account of 4.175 percent.

SOURCE: Social Security Administration, Advisory Council on Social Security, *Final Report* (Washington, D.C.: U.S. Government Printing Office, 1997), Appendix II, p. 189.

- It would protect the basic economic security of future retirees by ensuring the solvency of the defined benefit system and creating a new, privately owned source of retirement income for all workers.
- It would raise national saving and thereby provide for greater capital formation needed to achieve higher long-term economic growth.
- It would prevent the return on contributions from falling to unacceptable levels and restore the faith of younger workers in the system.
- It would help part-time, self-employed, and contingent workers adjust to changing

labor market conditions by providing a new source of retirement benefits for those without employer-provided pensions.

The current Social Security system is *unsustainable*. A timely combined effort is needed on the part of the Administration and Congress to address the unavoidable challenges that face Social Security and America's aging population. Delayed action will only increase the magnitude of the problems facing Social Security. Changing the Social Security system today, thereby allowing reforms to be phased in gradually, is the only way to avoid harmful tax levels, benefit cuts, or massive budget deficits in the future.



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## Glossary

**Actuarial balance.** The difference between the summarized income rate and the summarized cost rate over a given valuation period, often expressed as a percentage of covered wages.

**Actuarial deficit.** A negative actuarial balance.

**Actuarial equivalent.** Benefit having the same present value as the benefit it replaces. Also, the amount of annuity that can be provided at the same present-value cost as a specified annuity of a different type or a specified annuity payable beginning at a different age. For example, a lifetime monthly benefit of \$67.50 beginning at age 60 (on a given set of actuarial assumptions) may be said to be the actuarial equivalent of \$100 per month beginning at age 65.

**Adjusted gross income (AGI).** Amount of income potentially subject to federal income taxation, before consideration of exemptions and deductions.

**Administrative expenses.** Expenses incurred in administering Social Security payments or asset fund management. In the case of Social Security, such administrative expenses are paid from the OASI and DI trust funds.

**Advisory Council on Social Security.** Prior to the enactment of the Social Security Independence and Program Improvements Act of 1994 (Public Law 103-296), the Social Security Act required the appointment of an Advisory Council every four years to study and review the financial status of the OASDI and Medicare programs. The most recent Advisory Council was appointed on June 9, 1994, and published its final report in January 1997. Under the provisions of Public Law 103-296, this is the last Advisory Council to be appointed.

**Annuity.** An arrangement to provide an income for a specified number of years, or for the remaining lifetime of an individual, or the remaining lifetime of more than one individual.

**Assets, Social Security Trust Fund.** Treasury notes and bonds, other securities guaranteed by the federal government, certain federally sponsored agency obligations, and cash, held by the trust funds for investment purposes.

**Assumptions.** Values relating to future trends in certain key factors which affect the balance in the trust funds. Demographic assumptions include fertility, mortality, net immigration, marriage, divorce, retirement patterns, disability incidence, termination rates, and changes in the labor force. Economic assumptions include unemployment, average earnings, inflation, interest rates, and productivity. Three sets of economic assumptions are presented in the Social Security Annual Report of the Board of Trustees representing high, intermediate, and low costs. Alternative II is the intermediate set of assumptions and represents the SSA's best estimates of likely future economic and demographic conditions.

**Automatic cost-of-living increase.** The annual increase in benefits, effective for December, reflecting the increase in the cost of living. The benefit increase equals the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) measured from the average over July, August, and September of the preceding year to the average for the same three months in the current year.

**Average indexed monthly earnings (AIME).** The amount of earnings used in determining the primary insurance amount (PIA) for most workers who attain age 62, become disabled, or die after 1978. A worker's actual past earnings are adjusted by changes in the "average wage index" in order to bring them up to their approximately equivalent value at the time of retirement or other eligibility for benefits.

**Average wage index.** The average amount of total wages for each year after 1950, including wages in noncovered employment and wages in covered employment in excess of the OASDI contribution and benefit base. These amounts are used to index the earnings of most workers first becoming eligible for benefits in 1979 or later and for automatic adjustments in the contribution and benefit base, bend points, earnings test exempt amounts, and other wage-related amounts.

**Baby boom.** The period from the end of World War II through the mid-1960s, usually identified as 1946 to 1964, marked by unusually high birth rates.

**Bend points.** The dollar amounts defining the AIME or PIA brackets in the benefit formulas.

**Beneficiary.** A person who has been awarded benefits on the basis of his or her own or another's earnings record.

**COLA.** See "Automatic cost-of-living increase."

**Constant dollars.** One or more financial amounts adjusted by the CPI to a constant year as a reference point.

**Contribution and benefit base.** Annual dollar amount above which earnings in employment covered under the OASDI program are neither taxable nor creditable for benefit computation purposes. (Also referred to as "maximum contribution and benefit base" or "maximum taxable income.")

**Contributions.** The payroll tax paid, based on a percentage of earnings, up to an annual maximum.

**Cost-of-living increase.** See "Automatic cost-of-living increase."

**Covered earnings.** Earnings in employment covered by the OASDI program.

**Defined benefit plan.** A pension plan providing a defined benefit formula for calculating benefit amounts, such as a flat amount per year of service, a percentage of salary, or a percentage of salary times years of service.

**Defined contribution plan.** A pension plan in which the contributions are made to an individual account for each employee. The retirement benefit is dependent upon the account balance at retirement. The balance depends upon amounts contributed, investment experience, and in the case of profit sharing plans, amounts that may be allocated to the account because of forfeitures by terminating employees.

**Earnings test.** The provision requiring the withholding of benefits if beneficiaries under age 70 have earnings in excess of certain exempt amounts.

**Federal Insurance Contributions Act (FICA).** Provision authorizing taxes on the wages of employed persons to provide for Retirement, Survivors, and Disability Insurance and for

Hospital Insurance. The tax is paid in equal amounts by workers and their employers.

**Index funds.** Stock or bond portfolios structured so their risk levels and expected returns closely approximate those of stock or bond market indexes.

**Individual retirement account (IRA).** A retirement account to which a worker can make annual tax-deductible contributions for himself or herself up to \$2,000 or 100 percent of compensation, whichever is less, and up to \$2,000 for a nonworking spouse.

**Intermediate assumptions.** See "Assumptions."

**Long range.** The next 75 years. Long-range actuarial estimates are made by the SSA for this period because it is approximately the maximum remaining lifetime of current Social Security participants.

**Maximum family benefit.** The maximum monthly amount that can be paid on a worker's earnings record. Whenever the total of the individual monthly benefits payable to all the beneficiaries entitled on one earnings record exceeds the maximum, each dependent's or survivor's benefit is proportionately reduced to bring the total within the maximum. Benefits payable to divorced spouses or surviving divorced spouses are not reduced under the family maximum provision.

**Medicare.** A nationwide, federally administered health insurance program authorized in 1965 to cover the cost of hospitalization, medical care, and some related services for most people over age 65, and people receiving Social Security Disability Insurance payments for two years. Medicare consists of two separate but coordinated programs: Part A (Hospital Insurance, or HI) and Part B (Supplementary Medical Insurance, or SMI). All persons entitled to HI are eligible to enroll in the SMI program on a voluntary basis by paying a monthly premium. Health insurance protection is available to Medicare beneficiaries without regard to income.

**Normal retirement age.** The age at which a person may first become entitled to unreduced retirement benefits. Currently age 65, but scheduled under present law to increase gradually to 67 for persons reaching that age in 2027 or later, beginning with an increase to 65 years and 2 months for persons reaching age 65 in 2003.

**Old-Age and Survivors Insurance (OASI) Trust Fund.** See "Trust fund."

**Pay-as-you-go financing.** A financing plan under which taxes are scheduled to produce just as much income as required to pay current benefits, with trust fund assets built up only to the extent needed to prevent exhaustion of the fund by random economic fluctuations.

**Payroll taxes.** A tax levied on the gross wages of workers, up to maximum taxable income.

**Portability.** The right of an employee at termination of employment to take vested benefits in cash and transfer the funds to an individual retirement account or another pension plan.

**Present value.** The equivalent value, at the present time, of a future stream of payments (either income or expenditures). The present value of a future stream of payments may be thought of as the lump-sum amount that, if invested today, together with interest earnings would be just enough to meet each of the payments as they fell due.

**Primary insurance amount (PIA).** The monthly amount payable to a retired worker who begins to receive benefits at normal retirement age or (generally) to a disabled worker. This amount is related to the worker's average monthly wage or average indexed monthly earnings.

**Primary insurance amount formula.** The mathematical formula relating the PIA to the AIME for workers who attain age 62, become disabled, or die after 1978. The PIA is equal to the sum of 90 percent of AIME up to the first bend point, plus 32 percent of AIME above the first bend point up to the second bend point, plus 15 percent of AIME in excess of the second bend point.

**Reallocation of tax rates.** An increase in the tax rate payable to either the OASI or DI Trust Fund, with a corresponding reduction in the rate for the other fund, so that the total OASDI tax rate is not changed.

**Retired-worker benefit.** A monthly benefit payable to a fully insured retired worker age 62 or older.

**Retirement age.** The age at which an individual establishes entitlement to retirement benefits. See also "Normal retirement age."

**Social Security Act.** Provisions of the law governing most operations of the Social Security program. Original Social Security Act is Public Law 74-271, enacted August 14, 1935. With subsequent amendments, the Social Security Act

consists of 20 titles, of which 4 have been repealed. The Old-Age, Survivors, and Disability Insurance program is authorized by Title II of the Social Security Act.

**Special public-debt obligation.** Securities of the U.S. government issued exclusively to the OASI, DI, HI, and SMI trust funds and other federal trust funds. Section 201(d) of the Social Security Act provides that the public-debt obligations issued for purchase by the OASI and DI trust funds shall have maturities fixed with due regard for the needs of the funds. The usual practice in the past has been to spread the holdings of special issues, as of each June 30, so that the amounts maturing in each of the next 15 years are approximately equal. Special public-debt obligations are redeemable at par value at any time and carry interest rates determined by law.

**Supplemental Security Income (SSI).** A federally administered program (often with state supplementation) of cash assistance for needy aged, blind, or disabled persons. SSI is funded through the general fund of the Treasury and administered by the Social Security Administration.

**Survivor benefit.** Benefit payable to a survivor of a deceased worker. For a spouse with no Social Security benefits of his or her own, this payment equals 100 percent of the worker's PIA.

**Taxable earnings.** Wages and/or self-employment income, in employment covered by the OASDI and/or HI programs, that is under the applicable annual maximum taxable limit. For 1994 and later, no maximum taxable limit applies to the HI program.

**Taxation of benefits.** From 1984 to 1993, up to one-half of an individual's or a couple's OASDI benefits was potentially subject to federal income taxation under certain circumstances. The revenue derived from this provision was allocated to the OASI and DI trust funds on the basis of the income taxes paid on the benefits from each fund. Beginning in 1994, the maximum portion of OASDI benefits potentially subject to taxation was increased to 85 percent. The additional revenue derived from taxation of benefits in excess of one-half, up to 85 percent, is allocated to the HI trust fund.

**Trust fund.** Separate accounts in the U.S. Treasury in which are deposited the taxes received under

the Federal Insurance Contributions Act, the Self-Employment Contributions Act, contributions resulting from coverage of state and local government employees, any sums received under the financial interchange with the railroad retirement account, voluntary hospital and medical insurance premiums, and transfers of federal general revenues. Funds not withdrawn for current monthly or service benefits, the financial interchange, and administrative expenses are invested in interest-bearing federal securities, as required by law; the interest earned is also deposited in the trust funds.

- **Old-Age and Survivors Insurance (OASI).** The trust fund used for paying monthly benefits to retired-worker (old-age) beneficiaries and their spouses and children and to survivors of deceased insured workers.
- **Disability Insurance (DI).** The trust fund used for paying monthly benefits to disabled-worker beneficiaries and their spouses and children and for providing rehabilitation services to the disabled.

- **Hospital Insurance (HI).** The trust fund used for paying part of the costs of inpatient hospital services and related care for aged and disabled individuals who meet the eligibility requirements.
- **Supplementary Medical Insurance (SMI).** The trust fund used for paying part of the costs of physicians' services, outpatient hospital services, and other related medical and health services for voluntarily enrolled aged and disabled individuals.

**Unfunded liabilities.** Liabilities of the pension fund for which there are not sufficient assets to pay.

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SOURCES: Social Security Administration, *Annual Report of the Board of Trustees of the Federal Old-Age, Survivors, and Disability Insurance Trust Funds*, 1996 (Washington, D.C.: U.S. Government Printing Office, 1996); and U.S. Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions 1992* (Washington, D.C.: U.S. Government Printing Office, 1992).

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## Memoranda of Comment, Reservation, or Dissent

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Page 16, JAMES Q. RIORDAN

The report does a great service by clearly explaining that the existing Social Security system is financially unsound and needs fixing. The system cannot pay promised benefits at current levels of contribution. The system will give a very poor return on the contributions of the young. The system reduces national savings because it is unfunded.

The report has two basic recommendations.

The first, with which I agree, mandates a new forced retirement savings program (for 3 percent of covered payroll). The contributions will go into individual accounts and will not be available to the government to spend or redistribute. The new program should increase national savings. It will not misrepresent the size of the real deficit. It will give a fair market return on each dollar contributed. It will do all the things that the existing Social Security retirement system fails to do.

The second recommendation, with which I do not agree, recommends that we maintain the basic outline of the existing Social Security retirement system which absorbs 10+ percent of covered payroll. The report recommends that certain Social Security retirement benefits be reduced so that benefits can be funded without increasing the current level of contribution. The revisions recommended would hopefully avoid insolvency of the current system but would not fix any of its inherent problems.

The report supports the continuation of a system that incorporates a welfare program within a savings program. The blend has confused policy makers and misled the public. Sound policy requires us to consider the welfare and savings programs separately. The Social Security retirement plan recommended by the report will continue to be an unfunded defined benefit retirement program. Being unfunded it will add nothing to national savings. Since it continues to promise retirement benefits that will be paid for by somebody other than the beneficiaries, it will continue

to reduce incentives for private savings. It will also continue to give a terribly low return to young people — especially those earning from \$30,000 to \$65,000 per annum. The current system is a very poor savings program. The reason for the low rate of return is that the program redistributes the contributions primarily of the young to provide welfare benefits primarily to older people. Giving older people extra money is a compassionate act, especially if they are poor, but it is terribly unfair to focus the burden of such gifts on young people making less than \$65,000 per annum. The current system pays for its welfare program in a very unfair way. Everyone deserves a fair market return on his Social Security retirement contribution. If we choose to give some retirees more than a fair market return on their contributions, we should not pay for the transfer by giving the young less than a market return. **We should finance redistributive welfare payments from general revenues augmented, as needed, by a consumption tax paid by everyone.** We should not finance those payments from a capped payroll tax paid primarily by the young earning less than \$65,000 per annum.

Allocating 3 percent for real savings and 10+ percent for unfunded redistributive welfare is not a fair or productive way to handle payroll contributions. We should move increasing amounts of current Social Security retirement contributions into the new forced savings program and we should begin the move as soon as possible.

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Page 17, LAWRENCE A. WEINBACH

This report includes a number of recommendations designed to assure the long-range integrity of the Social Security retirement income program. One of those recommendations involves raising the normal retirement age of the Old-Age Survivors Insurance (OASI) program on a gradual basis to 70 beginning in the year 2000. The report also recommends that the normal retirement age be indexed to changes in average life expectancy after it reaches age 70 in the year 2030.

This report does not recommend an increase in the early retirement age since it is assumed that any early retirement benefit amounts will be fully reduced actuarially to assure that the payment of such benefits will be cost neutral to the OASI program. While I believe that cost neutrality is appropriate irrespective of the specified early retirement age, I believe there are other important reasons for increasing the current early retirement age under the OASI program.

Increasing the early retirement age would serve to assure that individuals are not provided with a real economic incentive to retire at 62 since Congress could be pressured to not fully actuarially reduce early retirement benefits (e.g., adjust monthly benefit amounts for number of payment considerations only). It also recognizes that, due to longer life spans, improved health conditions, changes in the nature of the workforce and workplace, projected “skills gaps,” historically inadequate savings rates and other factors, most individuals can and should be encouraged to work longer in the 21st century. Changing the early retirement age would send a signal to individuals, employers and unions to re-think their retirement plans based on these recent and expected changes. In addition, increasing the standard early retirement age recognizes that a significant number of individuals place an undue amount of weight on when they can first start receiving benefits in making their retirement decision rather than the projected adequacy of their benefits and other retirement resources throughout their retirement years.

Given the above, I believe the early retirement age under the OASI program should also be increased to age 65 on a phased-in basis. The early retirement age could also be indexed to changes in average life expectancy in a manner similar to the approach recommended for increasing the normal retirement age.

While I believe that the early retirement age should be raised, I also recognize that, due to the nature of certain occupations, some individuals

will not be able to work longer. Therefore, I believe that steps should be taken to allow certain individuals who can provide evidence of their inability to continue to work to be able to receive fully reduced early retirement benefits beginning at the current eligibility age (i.e., 62).

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Page 18, JOSH S. WESTON, with which PETER A. BENOLIEL has asked to be associated

This report does not address the many complex administrative issues involved in processing funds for 140 million individual retirement accounts, each of which permits employees to designate contributions to more than one fund. The task would be massive not only because of the size of the labor force but also because of the frequent changes in employment status. Over one-third of all workers — about 40 to 50 million individuals — change their employer or employment status (e.g., employed to not employed) each year.

Adding to the administrative complexity would be the need for a reliable, timely system for crediting accrued interest and dividends to each employee’s several funds each month and executing transfers between funds.

The report also does not address how fund administrators would be chosen and their number. There is no likely way, in my view, that an environment of multiple administrators, chosen by either the fund managers, employers, or employees, could handle this very complex movement of monies, investments, and employers. The only credible solution would be a single private, regulated administrator for all PRA accounts and funds. The Federal Thrift Savings Plan is in many ways a good model, although it is a public entity and permits transfers among funds only once per month. The two current public administration systems that affect all employees are the Social Security Administration and the Internal Revenue Service. Neither is sufficiently timely, nimble, and accurate to serve as a national PRA administrator.